

# Audit Report



DEFENSE LOGISTICS AGENCY PROCUREMENTS  
FROM FEDERAL PRISON INDUSTRIES, INC.

Report No. 99-001

October 5, 1998

Office of the Inspector General  
Department of Defense

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### **Acronyms**

DLA	Defense Logistics Agency
DSC	Defense Supply Center
FAR	Federal Acquisition Regulation
FPI	Federal Prison Industries, Inc.
NSN	National Stock Number
PQDR	Product Quality Deficiency Report



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October 5, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE PROCUREMENT  
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report of Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Report No. 99-001)

We are providing this report for review and comment. We conducted the audit in response to a congressional request. Comments provided by the Director, Defense Procurement and the Director, Defense Logistics Agency to the draft report were considered in preparing this final report.

DoD Directive 7650.3 requires that audit recommendations be resolved promptly. The Director, Defense Procurement comments were partially responsive. We request additional comments on Recommendation B. The Defense Logistics Agency comments were partially responsive. We request additional comments on Recommendation A.2.c. All additional comments should be provided by December 7, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Terry L. McKinney at (703) 604-9288 (DSN 664-9288) or Mr. Michael H. Claypool at (703) 604-9291 (DSN 664-9291). If management requests, we will provide a formal briefing on the audit results. See Appendix I for the report distribution.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman  
Assistant Inspector General  
for Auditing



## **Office of the Inspector General, DoD**

**Audit Report No. 99-001**  
(Project No. 7CF-5054)

**October 5, 1998**

### **Defense Logistics Agency Procurements From Federal Prison Industries, Inc.**

#### **Executive Summary**

**Introduction.** We initiated the audit as a result of a letter from Senator Carl Levin requesting a review of supplies and services procured by DoD from Federal Prison Industries, Inc.

**Audit Objectives.** The overall objective of the audit was to assess whether DoD procedures ensured that Federal Prison Industries, Inc. supplies were of appropriate "quality, character and suitability" and were purchased at "not to exceed current market prices" as required by law. We also determined whether contracting officials were requesting waivers of the mandatory requirement to purchase from Federal Prison Industries, Inc. when appropriate. We did not review Federal Prison Industries, Inc. services because they are not a mandatory source for the Federal Government and they must compete with the commercial sector for customer sales.

**Results.** Answers to Senator Levin's questions are in Appendix C. The Defense Logistics Agency has adequate procedures to ensure that Federal Prison Industries, Inc. supplies are of the appropriate quality, character, and suitability. Supplies were generally purchased at prices equal to, or better than, current market prices. However, the Federal Acquisition Regulation subpart 8.6, "Acquisition from Federal Prison Industries, Inc.," does not provide clear guidance on determining the current market price for purchases of supplies or the arbitration of disputes regarding price, quality, character, or suitability of supplies. DoD does not have Department-wide procedures for obtaining waivers from purchasing Federal Prison Industries, Inc. products, and the Department does not maintain waiver data. We identified three conditions requiring management action.

The statutory process and regulatory procedures for resolving disputes and appealing waiver denials are unworkable and are not being used by Federal Prison Industries, Inc. or Government customers. The FPI Ombudsman is the preferred option for dispute resolution, but this is not clear to DoD customers. As a result, DoD lacks effective means for initiating or appealing waiver requests and for resolving disputes regarding the price, quality, character, or suitability of Federal Prison Industries, Inc. supplies (Finding A).

Defense Supply Center (DSC), Richmond contracting officers paid higher prices than necessary for supplies purchased from both Federal Prison Industries, Inc. and commercial vendors. As a result, buyers missed opportunities to reduce the cost of supplies when purchasing items manufactured by both Federal Prison Industries, Inc. and commercial vendors. In contrast, DSC, Philadelphia used cost or price analysis and successfully negotiated more reasonable prices (Finding B).

Defense supply centers did not always obtain replacements for defective supplies manufactured by the Federal Prison Industries, Inc. As a result, the Defense supply centers missed the opportunity to replace about \$127,000 in defective items at no cost to Defense Logistics Agency (Finding C).

**Summary of Recommendations.** We recommend that the Director, Defense Procurement initiate revisions to Federal Acquisition Regulation subpart 8.6, "Acquisitions from Federal Prison Industries, Inc." We recommend that the Director, Defense Logistics Agency revise Defense Logistics Agency Directive 4105.1- "Defense Logistics Acquisition Directive," procedures for Federal Prison Industries Inc. dispute resolution. We recommend that the Commander, Defense Supply Center, Richmond establish additional training requirements for contracting officers and buyers who purchase supplies from Federal Prison Industries, Inc. We also recommend that the Director revise Defense Logistics Agency Manual 4155.2, 4-6, "Customer/Depot Complaints (CDCs)/Product Quality Deficiency Reports (PQDRs)," to indicate that the Federal Prison Industries, Inc. lifetime warranty applies to all of its supplies. We also recommend that the Commanders, Defense Supply Center Richmond and Philadelphia request Federal Prison Industries, Inc. to replace their defective supply items reported on the product quality deficiency reports.

**Management Comments.** The Director, Defense Procurement agreed that the Ombudsman is currently the primary adjudicator of disputes with Federal Prison Industries, Inc.; however, the Director stated that it is premature to revise Federal Acquisition Regulation subpart 8.6 until after a new arbitration board develops procedures, including its relationship with the Ombudsman. The Director agreed that "waiver" should be substituted for the term "clearance" for clarification in the regulation. The Director deferred recommending a revision to Federal Acquisition Regulation subpart 8.6 until a DoD report to Congress addressing the statutory, regulatory, and procedural framework governing the way DoD does business with Federal Prison Industries, Inc. is finalized. The Director did not agree that Federal Acquisition Regulation subpart 8.6 should be revised to include a definition of fair market price and how to determine fair market price for mandatory Federal Prison Industries, Inc. products. The Director stated that the Federal Acquisition Regulation is adequate and there is no need for further definition.

The Defense Logistics Agency agreed to revise Defense Logistics Agency Directive 4105.1, subpart 8.6, to refer to the Ombudsman waiver process. The Defense Logistics Agency Supply Center Richmond has established new long-term contracts which focus on improved pricing. Agency guidance will be revised to state that Federal Prison Industries, Inc. provides a life time warranty for all their products. Defense Logistics Agency also stated that it is premature to establish agency guidance on criteria for waiver requests or for appealing waiver denials until the results of the mandated DoD report is submitted to Congress. See Part I for a discussion of management comments, and Part III for a complete text of management comments.

**Audit Response.** The Director of Defense Procurement and Defense Logistics Agency's responses are partially responsive to the recommendations. We agree on deferring revisions to Federal Acquisition Regulation subpart 8.6 and to Defense Logistics Agency guidance until after the mandated DoD report is issued to Congress. In response to the final report, we request that the Director of Defense Procurement reconsider her position on revising the Federal Acquisition Regulation subpart 8.6 to include a definition of current market price. We also request that Defense Logistics Agency reconsider the recommendation to revise Defense Logistics Agency Directive 4105.1, subpart 8.6, to include criteria for requesting and appealing waivers to Federal Prison Industries, Inc. We request that the Director of Defense Procurement and the Defense Logistics Agency provide comments by December 7, 1998.

# **Table of Contents**

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## **Executive Summary**

## **Part I - Audit Results**

Audit Background	2
Audit Objectives	3
Finding A. Dispute Resolution	4
Finding B. Negotiated Prices for Mandatory Supplies	11
Finding C. Exercising Federal Prison Industries, Inc. Warranty	20

## **Part II - Additional Information**

Appendix A. Audit Process	
Scope	24
Methodology	25
Audit Period and Standards	25
Use of Computer-Processed Data	25
Appendix B. Prior Audits and Other Reviews	26
Appendix C. Senator Levin's Questions	27
Appendix D. Department of Justice Opinion	35
Appendix E. FAR Guidance for Commercial Contracts	47
Appendix F. Comparison of Federal Prison Industries, Inc. and Commercial Vendor Unit Prices	50
Appendix G. Item Description of Product Quality Deficiency Reports	51
Appendix H. Comparison of Delinquent Federal Prison Industries, Inc. and Commercial Deliveries	52
Appendix I. Report Distribution	54

## **Part III – Management Comments**

Office of the Under Secretary of Defense Comments	58
Defense Logistics Agency Comments	61





## **Part I - Audit Results**

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## Audit Background

In his July 1997 letter, Senator Carl Levin wanted to know whether DoD has improved its procedures for purchasing supplies and services from Federal Prison Industries, Inc. (FPI) since the last Inspector General, DoD audit in 1991. In October 1991, the Inspector General, DoD reported that, in 48 of 54 audited FPI contracts, prices paid for electronics and electrical cables purchased from FPI exceeded costs and profits negotiated in the contracts. These contracts were overpriced by an average of 15 percent because FPI actual contract costs were less than its negotiated costs and profits. See Appendix C for Senator Levin's questions and answers determined during our audit.

**Statute.** FPI is a self-supporting, wholly-owned Government corporation created in 1934 by 18 United States Code (U.S.C.), Sections 4121-4128 (the statute) and by an Executive Order. FPI operates by a statutory mandate to "provide employment for the greatest number of those inmates in the U.S. penal and correctional institutions who are eligible to work as is reasonably possible. . . ." Using paid inmate labor, FPI makes a variety of supplies such as furniture, military clothing and textiles, electrical cables and connectors, metal signs, and Government publications and graphics.

While FPI is prohibited from selling supplies to the public in competition with private sector enterprises, it has been granted a preference in product sales to United States Government activities. The statute requires Federal departments, agencies, and institutions to "purchase at not-to-exceed current market prices such products of the industries [FPI] authorized by this chapter as meet their requirements and may be available." The statute requires that all disputes about price, quality, character, or suitability of FPI supplies be resolved by an arbitration board. The decision of the arbitration board is "final and binding upon all parties."

**Department of Justice Opinion.** Because of the Inspector General, DoD Report issued in October 1991, the Director, Federal Bureau of Prisons requested that the United States Department of Justice provide an opinion on whether certain Federal procurement statutes and provisions of the Federal Acquisition Regulation (FAR) apply to FPI. In September 1993, the Department of Justice replied to the Director and Commissioner, Federal Prison Industries, Inc., stating, "the provisions of the FAR governing the submission of certified cost or pricing information, the calculation of a 'reasonable price' other than market price, and the general FAR procedures for resolving pricing disputes do not apply to FPI." No opinion was provided on the FPI method for determining current market price of its supplies by reference to the actual price of the same or similar supplies purchased in the past. However, it was opined that FPI may use any method that reliably estimates current market prices.

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The mandatory preference granted FPI is an exception to the rules that normally govern the way goods are procured by the United States. Typically, Federal procurement is governed by FAR 48 C.F.R., Subsection 1.000-51.205, a detailed set of procedures and forms promulgated pursuant to the Office of Federal Procurement Policy Act of 1974 (Procurement Act), 41 United States Code, Section 401-424. The Procurement Act embodies a number of policy goals, including promoting full and open competition; . . . promoting the development of simplified uniform procurement processes; [and] promoting fair dealings and equitable relationships with the private sector.

Appendix D has the complete text of the Department of Justice opinion.

**Federal Acquisition Regulation.** Federal Acquisition Regulation (FAR) subpart 8.6 - "Acquisition from Federal Prison Industries, Inc." is the implementing regulation to Federal procurement law and contains special provisions relating to acquisitions from FPI, including procedures resolving disputes about the price, quality, and character of supplies. Section 8.602, "Policy," provides that:

Agencies shall purchase required supplies for the classes listed in the Schedule of Products made in Federal Penal and Correctional Institutions at prices not to exceed current market prices, using the procedures of this subpart.

Except for FAR subpart 8.6, FAR policies and guidance do not apply to purchases from FPI. The Federal procurement statutes goals of increasing competition and facilitating purchase of commercial supplies cannot be promoted because supplies must be purchased from FPI by Federal Government customers.

## **Audit Objectives**

The primary audit objective was to determine whether DoD has procedures to ensure that FPI products and services are of appropriate "quality, character and suitability" and are purchased at "not-to-exceed current market prices" as required by public law. We also evaluated the reasonableness of prices, quality, and timeliness of delivery of FPI products and services compared to products and services that are purchased from the commercial sector. Senator Levin asked that we determine if contracting officials are requesting a waiver of the requirements to purchase products and services from FPI when products and services are over-priced or unsuitable for DoD use. See Appendix A for a discussion of the audit process. Appendix B has a summary of prior audit coverage related to the audit objectives.

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## Finding A. Dispute Resolution

The statutory process and regulatory procedures for resolving disputes and appealing waiver<sup>1</sup> denials are unworkable and are not being used by Federal Prison Industries, Inc. or Government customers. This condition exists because FAR subpart 8.6, "Acquisition from Federal Prison Industries, Inc." guidance does not clearly establish procedures for processing waivers and resolving disputes between FPI and its customers. As a result, DoD lacks effective means for initiating or appealing waiver requests and for resolving disputes regarding the price, quality, character, or suitability of FPI supplies.

### Guidance

Current guidance for resolving disputes that arise between FPI and its customers is embodied in law, a Department of Justice Memorandum, the FAR, an FPI letter commenting on a FAR case, and in a Defense Logistics Acquisition Directive. The intent of this collection of policy and procedural guidance is to provide an orderly process for resolving disputes between FPI and its customers. To the contrary, we found the guidance confusing, impractical, and often subject to conflicting interpretation.

**Statute.** 18 U.S.C. 4124 (b) "Purchases of prison-made products by Federal Departments," provides guidance on resolving disputes between FPI and its customers.

Disputes as to price, quality, character, or suitability of such products shall be arbitrated by a board consisting of the Attorney General, the Administrator of General Services, and the President, or their representatives.

This statutory provision for resolving disputes is not practical. First, the board has not functioned since the 1930s and the three primary members have not even designated representatives. Second, only an especially persistent contracting officer would assume that the dispute was of such importance that it should be resolved by the President, Attorney General and Administrator of GSA.

**Justice Department Memorandum.** Normally, the general provisions of the law relating to procurement policy and procedures are augmented by the FAR. The FAR includes provisions in subpart 33.2 for resolving disputes. However, the

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<sup>1</sup> By common consensus the term "waiver" rather than "clearances" is used to describe relief from the requirement to purchase the supplies from FPI.

provisions in subpart 33.2 cannot be used for resolving disputes between FPI and its customers according to a Department of Justice memorandum.

In a September 13, 1993 Department of Justice memorandum the Acting Assistant Attorney General offered the following legal opinion.

The pertinent statutory and regulatory framework treats FPI transactions separately from those with private sector entities with respect to dispute resolution. Subpart 33.2 of the FAR sets out regulations governing "Disputes and Appeals" in accordance with the Contract Disputes Act of 1978. In contrast, FPI's authorizing legislation expressly commits all disputes as to the "price, quality, character or suitability" of FPI products to a special arbitration board, and makes the finding of that board "binding upon all parties." In recognition of this law, subpart 8.6 of the FAR contains provisions that expressly preserve FPI's dispute resolution procedure.

. . . we believe the correct reading of the relevant statutes and regulations, taken as a whole, is that FPI is not covered by the FAR's standard terms, and instead, FPI must be treated specially under its authorizing legislation and FAR subpart 8.6.

This opinion makes it clear that only FAR subpart 8.6 (FAR 8.6) applies to FPI acquisitions. Other parts of the FAR provisions for waivers, disputes, cost and price analysis, and contract negotiations are not applicable to FPI. Appendix D has the complete text of the Department of Justice Opinion.

## **Disputes Resolution**

FAR 8.6 guidance has not been revised to clearly establish procedures for processing waivers and resolving disputes between FPI and its customers. Because the Justice Department determined that standard FAR provisions concerning disputes do not apply to purchases from FPI, any disputes between FPI and its customers must rely on FAR 8.6 and 18 U.S.C. 4124 guidance.

FAR 8.6 does not contain provisions on how disputes between FPI and its customers are to be resolved, but simply makes reference to and restates the law. Furthermore, FAR 8.6, as written, incorrectly describes the membership of the arbitration board, naming the Comptroller General of the United States instead of the Attorney General as one of the three members.

**Ombudsman.** The Ombudsman method for resolving customer disputes is not mentioned in either FAR 8.6 or the law. Although the authority of the Ombudsman to act in this capacity is not clear, this is the customer disputes process currently being used along with other informal processes, such as appealing customer disputes to FPI senior management for resolution.

## **Finding A. Dispute Resolution**

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Recognizing that the statutory procedures for resolving disputes is impractical, the FPI General Counsel, in a November 1997 letter to the Civilian Agency Acquisition Council, "FAR Case 96-608," said:

Regarding the Ombudsman: we appreciate your concurrence with our recommendation that a reference be placed in the FAR indicating that the Ombudsman is the approved method of resolving disputes. We suggest that the proposed language at FAR 8.605(c) read that "agencies should [rather than 'may'] address disputes to the FPI Ombudsman."

The FPI General Counsel also stated:

[The] statutory process is so impractical and so unwieldy that it has not been used since the 1930s and thus, for all practical purposes, is non existent. Therefore, purchasing offices should be encouraged to use the Ombudsman process to resolve disputes concerning waivers to the greatest extend possible.

The general counsel also recommended that the term "clearance" in FAR 8.6 be revised to "waiver" as more appropriate terminology related to customer disputes.

**DoD Guidance.** Except for the Defense Logistics Agency, the Department and the Services have not issued guidance concerning transactions with FPI. While DLA has published guidance, its guidance almost exclusively concerns issues related to price determination and negotiation. DLA Directive 4105.1, "Defense Logistics Acquisition Directive," subpart 8.6 "Acquisition from Federal Prison Industries, Inc.," provides policy, ordering procedures, and waiver guidance for FPI supplies. DLA's subpart 8.605 - "Clearances" states:

The guidance at [DLAD] 8.706, 8.790, and 8.791 also applies, in general to items that are proposed for inclusion on the FPI Schedule of Products. Where the coverage refers to JWOD<sup>2</sup> (NIB/NISH)<sup>3</sup> agencies or the Committee, the term is substituted therefore. Where it refers to the Procurement List, the term Schedule of Products will be substituted. To expedite the determination of FIP's [sic FPI's] capability and capacity to produce an item, a cooperative interface should be established between FPI's staff and Center technical staff.

This guidance is not applicable to the FPI waiver and disputes process. DLAD subpart 8.7 - "Acquisitions from Nonprofit Agencies Employing People Who Are Blind or Disabled," refers to guidance for Government customers to receive permission through a waiver to purchase mandatory supplies from the private sector rather than purchases from FPI.

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<sup>2</sup> Javits-Wagner-O'Day Act.

<sup>3</sup> National Industries for the Blind (NIB)/National Industries for the Severely Handicapped (NISH).

## **Waivers and Disputes**

DoD lacks effective procedures for initiating waiver requests and for resolving disputes regarding the price, quality, character, or suitability of FPI supplies. Even though current guidance is impractical, general and, at best, subject to various interpretations, FPI customers are requesting waivers and disputes are being resolved by an Ombudsman process.

Since FAR 8.6 makes no reference to the Ombudsman process, contracting officers may not be fully aware of the current waiver and disputes resolution process being used by FPI. We believe that the number of DoD customer waiver requests and appeals of denied waiver requests would be greater if clear, written procedures existed.

**DoD Waivers.** We relied on FPI waiver data statistics because DoD does not maintain a waiver data base. For FY 1997 DoD Departments and Services submitted 9,174 waiver requests estimated at \$230 million with 7,633 waiver requests approved by FPI. The waiver approvals were primarily granted on the basis of FPI prices, delivery timeliness, and specifications that did not meet the customers' requirements. FPI denied 1,541 waiver requests or 16.82 percent of the DoD waiver requests, which had an estimated value of \$39.2 million. DoD customers appealed 189 of the waiver denials to the Ombudsman, representing about 12 percent of the denied waivers. DLA appealed only one waiver denial for this period.

**Waiver Appeals.** According to the FY 1996 FPI Annual Reports, civilian and DoD customers appealed 172 waiver denials estimated at \$38.4 million to the Ombudsman. Of the \$38.4 million in waiver appeals, the Ombudsman approved \$27 million which allowed Federal customers to purchase the supplies from the commercial sector. During FY 1997, customers appealed 249 waiver denials estimated at \$22.5 million and 72 percent of the denied waivers were overturned by the Ombudsman and customers were permitted to purchase the supplies from the commercial sector. DoD customers initiated 189 of the 249 appeals submitted during FY 1997.

## **Conclusion**

FAR 8.6 should be revised to ensure that effective procedures are in place for initiating waivers and resolving disputes to include:

- Reference to the Ombudsman as the person to whom disputes between FPI and its customer should be referred.
- Criteria for when a waiver should be requested, for example, when the proposed FPI price is significantly higher than the current market price, or the FPI delivery schedule does not meet Department needs.

## **Finding A. Dispute Resolution**

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- “Waiver” instead of the term “clearance” to reflect the terminology actually being used by FPI and its customers.

We recognize that a FAR revision often requires a lengthy administrative coordination process that affects many different Government organizations. Accordingly, we believe that DLA should immediately revise DLAD 4105.1, subpart 8.6 “Acquisition from Federal Prison Industries, Inc.” to provide guidance to contracting officers and buyers for resolving disputes, requesting waivers, and appealing waiver denials with FPI.

## **Recommendations, Management Comments, and Audit Response**

**A.1. We recommend that the Director, Defense Procurement initiate revisions to the Federal Acquisition Regulation subpart 8.6 “Acquisition from Federal Prison Industries, Inc.” that:**

**a. Refers buyers to the Ombudsman as the approved method of resolving disputes pertaining to price, quality, suitability, and character of FPI products, and**

**b. Uses the word “clearance” instead of “waivers” to relate the terminology used with customer disputes.**

**A.2. We recommend the Director, Defense Logistics Agency revise Defense Logistics Agency Directive 4105.1- “Defense Logistic Acquisition Directive,” subpart 8.6 “Acquisition from Federal Prison Industries, Inc.” to:**

**a. Comply with Federal Acquisition Regulation subpart 8.6 and the 1993 Department of Justice Legal Opinion pertaining to Federal Prison Industries, Inc.**

**b. Refer buyers to the Ombudsman as the approved method of resolving disputes pertaining to price, quality, suitability, and character of FPI products.**

**c. Include criteria determining when to request a waiver to purchase Federal Prison Industries, Inc. mandatory products from commercial vendors and also the criteria for appealing a waiver denial.**

**Director, Defense Procurement.** The Director partially concurred with Recommendations A.1.a. and A.1.b., agreeing that the FPI Ombudsman is currently the primary adjudicator of disputes with FPI. However, because a new arbitration board referred to in FAR 8.605(c) is being established for dispute resolution it is premature to make changes to FAR 8.6 until the new board



develops procedures, including its relationship with regards to the FPI Ombudsman. The Director agrees that "waiver" should be substituted for the term "clearance" for clarification.

**Audit Response.** The Director's comments were responsive. We agree that it would be premature to revise FAR 8.6 until the new arbitration board develops procedures for dispute resolution. However, we believe that the Ombudsman will still be needed due to the number of Government customer waiver denial appeals received recently. During FY 1996 and FY1997, DoD customers appealed 361 waiver denials to the Ombudsman for adjudication. The new arbitration board will not be able to adjudicate hundreds of waiver appeals in an expeditious manner as required by FPI customers. We believe the current FPI waiver bureaucracy is an impediment to acquisition streamlining and clear procedures should be established as soon as practicable.

**Defense Logistics Agency, Comments.** DLA concurred with Recommendation A.2.a. and A.2.b., stating that DLA Directive 4105.1, subpart 8.6 is being revised, and reference to subpart 8.7 has been removed via PROCLTR 97-34. DLA stated that the FPI Ombudsman procedure seems such a simple, universally-recognized solution that its treatment seems appropriate and this procedure will be part of the complete revision of DLAD 4105.1, subpart 8.6. DLA nonconcurred with Recommendation A.2.c., stating that the current DoD/FPI study underway could have an impact on the DLA and DoD business relationships with FPI. The FY 1998 National Defense Authorization Act mandated a joint DoD/FPI study to address the statutory, regulatory, and procedural framework governing the DoD relationship with FPI. Until the results of the study group is published and submitted to Congress, it would be premature for DLA to establish criteria for waiver submission or for appealing waiver denials.

Although not required to comment on Finding A, DLA nonconcurred with the finding, stating that whatever the process for resolving disputes and appealing waiver denials, the solution is not to revise FAR guidance. The FAR governs contractual relationships between the Government and private-sector contractors. FAR 8.6 puts contracting officers and contractors on notice that, by statutory mandate, the Government is obligated to contract with FPI. Procedural guidance regarding the FPI waiver appeal process belongs elsewhere in the Code of Federal Regulations and in Departmental instructions.

**Audit Response.** DLA comments to Recommendations A.2a. and A.2b. were responsive. Regarding Recommendation A.2.c., in discussions with DLA Supply Center procurement personnel about FPI mandatory purchase requirements it was evident that the waiver criteria pertaining to price, quality, and timeliness was not clearly understood within the framework of FAR 8.6 and DLA 4105.1 guidance. Regardless of the results of the joint DoD/FPI study, DLA contracting officers will always need to know the acceptable criteria for requesting and appealing waivers from purchasing FPI products.

## **Finding A. Dispute Resolution**

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We disagree with DLA that the FAR is inappropriate for providing guidance on FPI purchases. We believe revising FAR 8.6 to include the FPI Ombudsman reflects a currently accepted procedure and clarifies the ambiguities regarding the waiver appeals process. In comments to the Civilian Agency Acquisition Council on FAR Case 96-608, the FPI General Counsel recommended that language be added to FAR 8.6 to indicate the Ombudsman is the approved alternative method of resolving disputes. We agree with the General Counsel's recommendation.

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## **Finding B. Negotiating Prices for Mandatory Supplies**

Defense Supply Center (DSC), Richmond contracting officers paid higher prices than necessary for supplies purchased from both FPI and commercial vendors. Contracting officers at DSC, Richmond did not always use price analysis to evaluate proposals or negotiate prices, when the proposed price was above the current market price. As a result, buyers missed opportunities to reduce the cost of supplies when purchasing items manufactured by both Federal Prison Industries, Inc. and commercial vendors. In contrast, DSC, Philadelphia used cost or price analysis and successfully negotiated more reasonable prices.

### **Laws and Regulations**

18 U.S.C. 4124 "Purchases of prison-made products by Federal Departments," provides guidance on purchases of supplies from prison industries.

- (a). The several Federal Departments and agencies and all other Government institutions of the United States shall purchase at not to exceed current market prices, such products of the industries authorized by this chapter as meet their requirements and may be available.

FAR 8.602 "Policy," requires

- (a). Agencies shall purchase required supplies of the classes listed in the Schedule of Products made in Federal Penal and Correctional Institutions (referred to in the subpart as 'the Schedule') at prices not to exceed current market prices using the procedures in this subpart.

While Federal law and FAR subpart 8.6 require Federal departments to purchase supplies from FPI at prices not-to-exceed the current market price, neither the statute nor the subpart define current market price or how the purchase office should determine the current market price for FPI purchases. FAR provisions relating to purchases of supplies from commercial vendors are included in Appendix E. While not applicable to purchases from FPI, FAR 15.402, "Pricing policy," provides guidance for contracting officers to purchase supplies and services at fair and reasonable prices. We believe that such procedures offer valuable techniques for contracting officers to adapt for purchases from FPI

## **Finding B. Negotiated Prices for Mandatory Supplies**

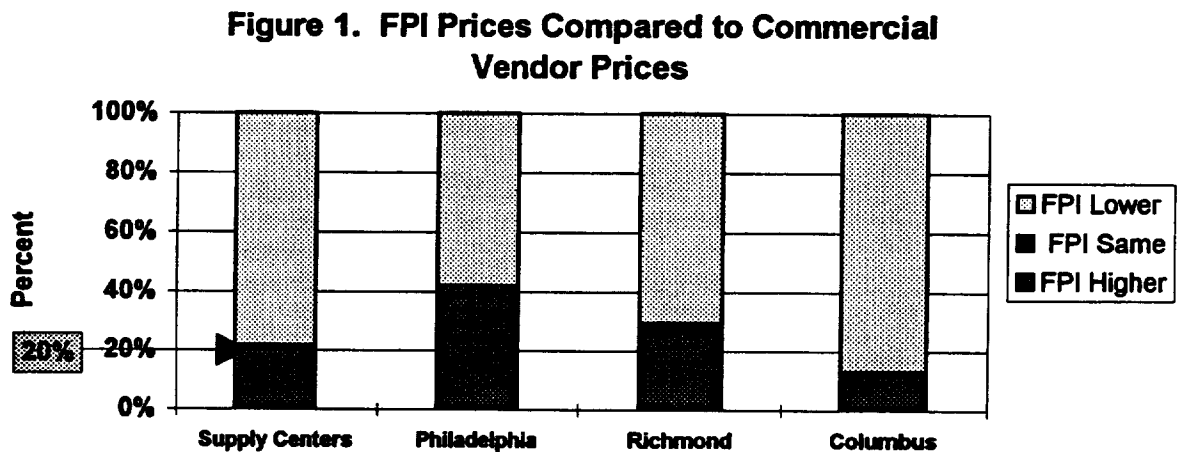
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### **Price Comparisons**

The Defense Logistics Agency contracting officers purchased supplies that could have been purchased at a lower price from either FPI or commercial vendors.

Using procurement data provided by 3 DLA centers, we made 1,352 price comparisons valued at \$324 million by matching commercial and FPI contracts for identical supplies. We compared contracts or modifications of earlier contracts dated after September 30, 1995.

Figure 1 shows the percentage of FPI price comparisons for which the unit price is lower, the same, and higher than the commercial prices.



In 1,352 comparisons 20 percent of the FPI unit prices were higher than the comparable commercial prices. Another 78 percent of the supplies were bought from contractors at higher prices than FPI unit prices. The remaining 2 percent of the price comparisons were the same.

### **Price Analysis and Negotiations**

The use of price analysis to evaluate proposals, or negotiate prices when the proposed price was above the current market price, varied between the DLA buying centers.

A buyer's analysis of a price proposal should have two primary objectives. The first is to establish that the proposed price is fair and reasonable and consistent

## **Finding B. Negotiated Prices for Mandatory Supplies**

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with the current fair market price. The second is to provide a basis for negotiating a lower price, if the offered price is unreasonable and in excess of the current market price.

We selected 27 FPI and commercial contracts to determine the reason for variations in unit prices for identical supplies. While our primary focus was to determine why a higher price was paid to FPI, we also examined contracts with higher commercial unit prices to determine why the higher commercial prices were paid.

The contracts we selected had been awarded by DLA centers in either Richmond or Philadelphia. We did not review contracts for the Columbus Center because the values of the variations at that Center were not material. The Richmond Center was permitted to purchase supplies from commercial vendors because FPI granted the Center an automatic waiver for purchases under \$3,500. A similar arrangement was not in existence at the other Centers.

Buyers were using three primary methods to determine price reasonableness. The method used varied by contract. Buyers used price analysis, cost analysis, and comparison of price quotations with unsolicited price quotations from commercial vendors. Price analysis generally uses the last price paid for the supplies and adjusts that price to a present value using the Department of Labor's Producer Price Index. Cost analysis is the review and evaluation of the separate cost elements and profit in an offer's proposal. This methodology is generally similar to the procedures in FAR 15.404-1, "Proposed Analysis Techniques," that are used for commercial vendor proposal analysis.

**Defense Supply Center, Richmond.** At the Richmond Center, buyers were not adequately performing price analysis or negotiating prices with FPI. We examined eight FPI contracts with FPI unit prices higher than the comparable commercial contract. The average value of the FPI contracts was \$125,260. The percentage by which the FPI price exceeded the commercial price ranged from 10 to 153 percent. At the same time we examined seven commercial contracts for which the unit price was higher than the comparable FPI unit price.

**Analysis of FPI contracts.** For the eight FPI contracts awarded by the Richmond Center, FPI provided an Estimated Cost Breakdown for material, labor, overhead, and profit to support its price proposal. However, buyers made little use of the cost breakdown for these contracts. For five of the eight FPI contracts, the buyers did not do price analyses using the last valid purchase price. Buyers primarily relied on Richmond's electronic spreadsheet to calculate the current market price (in lieu of performing a price analysis) based on the last valid unit price for buying the supplies. This resulted in excessive prices being paid. Only one of the five buyers requested waivers. Both waiver requests were based on the FPI price exceeding the current market price and FPI denied both requests. The requests were not appealed and the buyer ultimately purchased the supplies from FPI.

## **Finding B. Negotiated Prices for Mandatory Supplies**

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For example, a contract was awarded to FPI on December 19, 1996, at a unit price of \$70.90. The contract file included two commercial quotations dated November 1996. The commercial unit prices, in the quotations were \$40.49 and \$41.90. The commercial comparison contract, awarded May 27, 1997, was awarded at a unit price of \$37.40. Clearly, the \$70.90 unit price was excessive when compared with the commercial quotations and actual subsequent award to a commercial vendor. Had Richmond purchased the supplies from FPI at \$37.40 the total cost would have been nearly \$25,000 less.

Adequate training on the use of cost and price analysis and on price negotiation would have provided the buyers with skills to negotiate lower unit prices for contracts. The results of price analysis and successful negotiations with FPI were visible from the results of negotiating long term contracts with FPI and the outcome of negotiations by the more experienced buyers at the Philadelphia Center. Richmond should provide training and require its buyers to perform price analysis before purchasing supplies from FPI or commercial vendors. When the analysis shows that the FPI price significantly exceeds the current market price, and a lower price cannot be negotiated, the buyer should request a waiver from FPI. The benefits of such analyses have historically paid good dividends. For example, extensive negotiations between the Richmond Center and FPI for a 5 year contract for approximately 200 national stock numbers resulted in a contract being awarded to FPI with a total contract value \$3.4 million lower than FPI's initial proposed prices, a 12 percent price reduction.

**Waivers for Price.** The FAR, as currently written, serves to discourage waiver requests for reasons of price. FAR 8.605(b) states:

Purchases from other sources because of a lower price are not normally authorized, and clearances [waivers] will not be issued on this basis except as a result of action taken to resolve questions of price under 8.604(c).

Subpart 8.604(c) states:

When the contracting officer believes that the FPI price exceeds the market price, the matter may be referred to the cognizant product division identified in the Schedule or to the FPI Washington office for resolution.

FPI relies on this FAR language for resolution of price disputes as can be ascertained from an FPI letter to a Defense Supply Center Richmond contracting officer that stated:

I am writing in response to DGSC [sic DSC Richmond] continuing pricing request regarding DLAR 8.6-90(c)(2) and DGSCAP 8.604(c)(3)(ii) as they relate to disputes concerning Current Market Price determinations. Federal Prison Industries, Inc. (FPI) does not agree with the provisions of the DLAR and DGSCAP, insofar as they

## Finding B. Negotiated Prices for Mandatory Supplies

suggest that a contracting officer can unilaterally overrule FPI's determination as to what constitutes 'current market price.' In fact the DLAR may be in conflict with the FAR section 8.605 Clearance (b) 'Purchases from other sources because of a lower price are not normally authorized, and clearance will not be issued on this basis . . . .'

From our examination of Richmond contract files and discussions with buyers, we conclude that waivers that should have been submitted on the basis of price were not always submitted. The FAR 8.605(b) language should be changed to require the buyers to request a waiver when the FPI proposed price significantly exceeds the current market price.

**Analysis of Commercial contracts.** We judgementally selected seven commercial contracts with unit prices higher than the comparable FPI unit price. The value of each contract was less than \$25,000. We compared the seven contracts with the associated FPI contracts for identical supplies. Figure 3 presents the comparisons by national stock number.

Figure 3. Commercial Vendor Prices Compared to FPI Prices					
NSN	Commercial		FPI		Unit Price Difference
	Unit Price	Quantity	Unit Price	Quantity	
5995-01-380-3901	\$609.00	40	\$4.59	185	13167.97 %
5995-01-386-1646	\$588.00	10	\$219.09	10	168.38 %
6150-00-051-4868	\$1,180.00	4	\$356.40	4	231.09 %
6150-01-046-9800	\$212.03	42	\$127.17	19	66.73 %
6150-01-383-0806	\$1,077.00	7	\$138.59	15	677.10 %
6150-01-383-0806	\$1,085.85	9	\$138.59	15	683.50 %
6150-01-383-0806	\$1,201.21	3	\$138.59	15	766.74 %

We recognize that it may not be realistic for all commercial vendors to be as price competitive as FPI. However, the large percentage of differences found at the Richmond Center clearly demonstrates a need for better price analysis and negotiation.

Buyers at the Richmond Center had not performed a price analysis for the seven commercial contracts, relying exclusively on solicited and unsolicited price quotations from commercial vendors. Further, the contract files did not include any explanation of why the supplies were not purchased from FPI when the commercial prices for these supplies were higher. While FPI has provided the Richmond Center a blanket waiver for supplies costing under \$3,500, the

## **Finding B. Negotiated Prices for Mandatory Supplies**

application of this waiver should not be such that buyers overlook FPI as a source when FPI can provide the supplies at a lower unit price. To overlook FPI under such circumstances is not appropriate.

**Defense Supply Center, Philadelphia.** At the Philadelphia Center buyers performed cost and price analysis to establish that the price was fair and reasonable. We reviewed 12 FPI clothing and textile contracts for which the price paid to FPI was higher than the price paid to a commercial vendor for identical supplies. Each contract file included a Center cost and price analysis. We noted only one instance where the most recent commercial price had not been used in an analysis.

The Philadelphia Center's use of cost and price analysis clearly shows FPI is willing to negotiate prices. Such negotiations have permitted DoD to obtain more reasonable prices for supplies. Negotiations by the Philadelphia Center resulted in 8 of the 12 clothing and textile contracts awarded to FPI costing \$3.5 million less than originally proposed, a 9 percent decrease in FPI's prices. Figure 4 compares the unit prices initially offered and the negotiated final unit price.

<b>Figure 4. Results of Philadelphia Price Negotiations</b>					
<b>Contract</b>	<b>Initial Price</b>	<b>Contract Cost</b>	<b>Final Price</b>	<b>Contract Cost</b>	<b>Percent Saved</b>
SP010096DCA03	\$9.99	\$2,939,697	\$9.05	\$2,663,089	9.41 %
SP010096DCB62	\$3.07	\$4,353,751	\$3.03	\$4,297,025	1.30 %
SP010096FCB03	\$8.99	\$601,539	\$8.90	\$595,517	1.00 %
SP010096FCB20	\$9.00	\$272,052	\$8.19	\$247,567	9.00 %
SP010097DCB10	\$24.45	\$2,494,291	\$23.20	\$2,366,771	5.11 %
SP010097DCB11	\$24.75	\$4,743,833	\$21.20	\$4,063,404	14.34 %
SP010097FEA01	\$402.30	\$17,733,384	\$349.40	\$15,401,552	13.15 %
SP010098DCA01	\$9.77	\$402,368	\$9.11	\$375,186	6.76 %
<b>TOTALS</b>		<b>\$39,259,463</b>		<b>\$35,728,659</b>	<b>8.99 %</b>

The most successful negotiations were for contract SPO10097DCB11 (desert camouflage coat [14.34 percent saved]) and contract SPO10097FEA01 (body armor fragmentation vest [13.15 percent saved]).

## **Lower Cost**

DLA buyers and contracting officers at the Defense Supply Center, Richmond could have purchased the supplies in our comparisons at a lower price if its buyers



had purchased or been able to purchase the supplies at the lower of the FPI or commercial price. We recognize that not all of the supplies included in our comparison could have been purchased at the lower unit price because of considerations related to FPI manufacturing capacity and maintenance of the industrial base. Nevertheless the success of buyers when they negotiated prices persuaded us that there are opportunities to purchase supplies at less cost. For the 20 percent of the supplies that matched, FPI prices were higher than commercial sector prices. Had DLA been authorized to purchase these supplies at the lower of commercial unit prices or negotiated a comparable price with FPI, DLA could have reduced its costs by \$2.6 million.

We determined this savings by multiplying the difference in price between the higher FPI prices and the comparable commercial price by the number of items purchased from FPI and summed the results, which totaled \$2.6 million. Similarly for 78 percent of the comparisons, the commercial prices were higher than the FPI prices. If DLA could have purchased the supplies at the FPI price rather than the actual commercial price it could have reduced its costs by as much as \$10 million. Since all the supplies in our comparisons were included on the FPI schedule, DLA was required to obtain waivers from FPI before purchasing the supplies commercially. This was done and FPI granted waivers for the purchases.

## **Recommendations, Management Comments, and Audit Response**

**B.1. We recommend that the Director, Defense Procurement propose a revision to the FAR to eliminate the language in Subpart 8.605(b), which states that price will not normally be the basis for a waiver and insert:**

**a. A definition of current market price and how to determine current market price when:**

**(1) The supplies being purchased are of the kind generally bought and sold on the commercial market.**

**(2) The supplies are manufactured in accordance with Government specifications.**

**b. A requirement that waivers should be requested when the proposed Federal Prison Industries, Inc. price significantly exceeds the current market price.**

**B.2. We recommend that the Commander, Defense Supply Center Richmond establish additional training requirements for buyers and contracting officers purchasing from Federal Prison Industries, Inc. The training should include:**

## **Finding B. Negotiated Prices for Mandatory Supplies**

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**a. Cost and price analysis techniques and reemphasize of the requirements to perform price analysis to complement cost or other analysis;**

**b. Negotiating procedures when analysis shows that either Federal Prison Industries, Inc. or commercial suppliers quote prices substantially greater than the current market price; and**

**c. The conditions for requesting a waiver from Federal Prison Industries, Inc. and what action to take if they deny the waiver.**

**Director, Defense Procurement, Comments.** The Director deferred deleting Federal Acquisition Regulation 8.6 language which states that price will not normally be the basis for a waiver. The FY 1998 National Defense Authorization mandated report that is being prepared for Congress will address a number of issues concerning FPI. The Director prefers to negotiate any proposed FAR changes emanating from this report and the change the Inspector General recommends will be considered. Regarding Recommendations B.1.a. and B.1.b., the Director nonconcurred, stating that FAR 19.001, "Definitions," has a definition of the term "fair market price," and FAR 19.807, "Fair Market Price," has an explanation of how to determine fair market price. In addition, FAR 15.404-1, "Proposal Analysis Techniques," contains information on how to conduct a price analysis. This information is taught to contracting personnel as part of their required training. It would be redundant to repeat this information in FAR subpart 8.6. In addition, FAR 8.604(c) allows contracting officers to refer FPI prices exceeding the market price to cognizant FPI Headquarters personnel. This gives contracting officers enough flexibility to determine when to request a waiver if FPI will not reduce its proposed price. It is unnecessary to mandate that a waiver be requested if the FPI prices significantly exceed the current market price for the same or similar item.

**Audit Response.** We agree that it would be premature to revise FAR subpart 8.6 language but we do not agree that a FAR change is unneeded. We believe the Director misunderstood the intent of our recommendation, which is to clarify the term "fair market price" for mandatory supply items in relation to the minimum guidance provided by FAR 8.6 and the 1993 Department of Justice legal opinion that concluded FPI is not covered by the FAR standard terms when doing business with Government customers. Because FPI is not required to submit certified or uncertified cost or pricing data for contract proposals, the contracting officer or buyer is generally limited to comparative or alternative pricing methods to determine the fair market value of an FPI supply item. Comparative pricing has limited application for noncommercial military specification items, such as aircraft wiring harness, for which FPI has been the sole source producer in recent years. We believe the recommendation to revise FAR 8.6 language would provide clear parameters for contracting officers, minimize disagreements based on price issues, and support the DoD acquisition streamlining policy to minimize procurement bureaucracy. We disagree that FAR 8.604(c) provides contracting officers flexibility in addressing FPI supply prices that significantly exceed current market price. Frequently, the FPI Headquarters division or commodity manager that the

## **Finding B. Negotiated Prices for Mandatory Supplies**

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pricing issue is referred to is the same individual who either approves or disapproves the waiver request based on a pricing dispute. FAR 8.6 ambiguous language and the procedure for settling price disputes is a primary reason that the FPI Ombudsman was established to independently assess the merits of appealed waivers. We request that the Director reconsider the nonconcurrence and comment on the final report.

**Defense Logistics Agency, Comments.** DLA concurred with Recommendations B.2.a., B.2.b., and B.2.c., stating that the Defense Supply Center Richmond is in the process of establishing new long term contracts which focus on improved pricing with FPI. The supply center will also provide training for buyers and contracting officers on purchasing mandatory supply items from FPI. The training will include cost and price analysis techniques with emphasis on performing price analysis to complement cost or an alternative analysis. During FY 1999, the supply center has scheduled training on the waiver process. Because the waiver process is cumbersome and slow, the center will review and make changes to streamline the process to expedite buying decisions. Action is to be completed by December 1998.

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## **Finding C. Exercising Federal Prison Industries, Inc. Warranty**

Defense supply centers did not always obtain replacements for defective supplies manufactured by FPI. This occurred because Defense supply centers did not notify FPI about the defective supplies in order to exercise the warranty. Defense Logistics Agency guidance is incomplete pertaining to the lifetime warranty provided by FPI. As a result, the Defense supply centers missed the opportunity to replace about \$127,000 in defective items at no cost to Defense Logistics Agency.

### **The FPI Escape-Proof Warranty**

The FPI warranty guarantees the repair or replacement of any item at no cost to the buyer. The warranty is stated as follows:

We are committed to your complete and continual satisfaction. If, at any time, an item we have provided does not entirely meet your expectations, we will cheerfully and promptly repair or replace it, entirely at our expense.

**Product Quality Deficiency Report.** During October 1, 1994 through September 30, 1997, DLA received 337 Product Quality Deficiency Reports (PQDR) for deficiencies of supply items purchased from FPI. The 337 PQDRs reported 24,915 defective supply items. DLA did not always notify FPI about PQDRs.

**Defense Supply Center Philadelphia.** DSC Philadelphia received 296 PQDRs for 24,185 defective items such as T-shirts, camouflage trousers, and woman's utility shirts. The value for the 24,185 defective items reported is \$125,390.24. The supply center did not notify the FPI of the deficiencies in order to receive replacements for the defective items.

**Defense Supply Center Columbus.** DSC Columbus received 10 PQDRs for 153 defective electrical supply items. The value for the 153 defective items reported is \$2,132.07. Of the 10 PQDRs, only 3 were referred to Defense Contract Management Command for investigation and one PQDR had two defective supply items. The center has not received FPI replacements for the remaining 7 PQDRs with 121 defective items valued at \$1,696.30. DSC should request replacements for the defective items.

**Defense Supply Center Richmond.** The supply center received 31 PQDRs for 577 defective electrical items. The value for the 577 defective electrical items reported is \$46,222.34. The supply center contacted the FPI about the PQDRs. By FPI direction, the DoD customers returned the defective items for replacement. FPI paid for the shipping costs of the items returned.

## **Item Replacements**

The Defense supply centers did not always notify FPI about the defective supplies to exercise the warranty. The Inventory Control Point is responsible for determining if an item is under warranty and contacting FPI to inform them of the deficiency, according to Defense Logistics Agency Directive 4155.2, "Quality Assurance Program for DLA Inventory Control Points." The Directive states:

The ICP Action Point shall determine the corrective action to correct the deficiency. The Action Point shall make recommendations to contracting officers on contractual warranty enforcement; action to obtain contractor repair, replacement, or reimbursement of nonconforming materiel by the contractor . . .

**Knowledge of Warranty.** The DSC Philadelphia officials said they were not aware of the lifetime warranty that FPI offers on its clothing and textile supplies. Two factors contribute to this:

- DLA procedures that require Defense supply centers to exercise FPI warranty provisions are inadequate, and
- DLA guidance is incomplete pertaining to the lifetime warranty provided by the FPI.

DLA Manual 4155.2, 4-6, "Customer/Depot Complaints (CDCs)/Product Quality Deficiency Reports (PQDRs)," states that FPI has a lifetime warranty on its electronic supplies. However, the FPI warranty applies to all of its products.

## **Opportunity to Replace Defective Items**

Because the Defense supply centers did not exercise FPI warranty provisions, they missed the opportunity to replace about \$127,000 in defective supply items at no cost to Defense Logistics Agency.

## **Recommendations, Management Comments, and Audit Response**

**C.1. We recommend that the Headquarters, Defense Logistics Agency:**

**a. Revise Defense Logistics Agency Manual 4155.2, 4-6, "Customer/Depot Complaints (CDCs)/ Product Quality Deficiency Reports (PQDRs)," to state that the Federal Prison Industries, Inc. lifetime warranty applies to all of its supplies.**

**b. Require Defense supply centers to exercise the Federal Prison Industries Inc. warranty provisions for their products.**

**C.2. We recommend that the Commander, Defense Supply Center Philadelphia request Federal Prison Industries, Inc. to replace supply items associated with the 296 Product Quality Deficiency Reports that we reviewed.**

**C.3. We recommend that the Commander, Defense Supply Center Columbus request Federal Prison Industries, Inc. to replace supply items associated with the 7 Product Quality Deficiency Reports that we reviewed.**

**Defense Logistics Agency, Comments.** DLA concurred with all of the recommendations, stating that the Inventory Control Points will be required to follow DLA Directive 4155.2, "Quality Assurance Program for DLA inventory control points," that requires FPI to be notified about defective items reported on PQDRs. Agency guidance in DLA Instruction 4155.2, "Quality Assurance Program Instruction for DLA Inventory Control Points," will be amended to state that FPI's lifetime warranty applies to all FPI products. DLA Supply Centers Columbus and Philadelphia have initiated action to have FPI replace defective supply items if they caused the deficiency. Action is to be completed by December 1998.

## **Part II - Additional Information**

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## Appendix A. Audit Process

### Scope

DoD Components purchase supplies and services from FPI; however, we focused our review to include only DLA purchases from FPI during fiscal years 1996 and 1997. We reviewed data related to quality, price, and timeliness of supplies purchased by DLA. We also reviewed the DLA procedures used to request a waiver of the requirements to purchase mandatory supplies from FPI when supplies are overpriced or unsuitable for DoD use.

For October 1, 1995 through September 30, 1997, we reviewed 1,786 contracts in the DLA procurement data base to compare unit prices of FPI and commercial vendors' products of the same supply national stock number.

We reviewed the Customer Depot Complaints system for PQDRs for FPI supplies that had a recorded deficiency during October 1, 1994 through September 30, 1997.

We used the DLA Automated Best Value System, which rates contractor delivery performance, to review FPI supply delivery timeliness for a one year period. We also reviewed contract records for purchases of clothing and textile supplies from October 1, 1995 through September 30, 1997. We compared FPI and commercial vendor delivery performance for like supplies to evaluate delivery timeliness. We used data from "DPSC form 420, Contract Status Record" to compute the delinquency rate and the average number of days late for mandatory clothing and textile items.

We reviewed DLA waiver requests submitted to FPI for approval to purchase supplies from commercial vendors. We also reviewed data on reported DoD waiver requests, approvals, and denials from the FPI waiver data base. We did not verify FPI waiver data because it was not within the scope or authority of our audit.

We did not use statistical sampling procedures for this audit.

**DoD-wide Corporate Level Government Performance and Results Act (GPRA) Goals.** In response to the GPRA, the DoD has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

- **Objective:** Fundamentally reengineer the Department and achieve a 21st Century infrastructure. **Goal:** Reduce cost while maintaining required military capabilities across all DoD mission areas. (DoD-6)



**DoD Functional Area Reform Goals.** Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

- **Logistics Functional Area. Objective:** Streamline logistics infrastructure. **Goal:** Implement most successful business practices (resulting in reductions of minimally required inventory levels). (LOG-3.1).

**General Accounting Office High Risk Area.** The General Accounting Office (GAO) has identified several high risk areas in DoD. This report provides coverage of the Defense Inventory Management high risk area.

## **Methodology**

Specific methodology for each objective is discussed in Appendix C.

## **Audit Period and Standards**

We conducted this economy and efficiency audit from September 1997 through April 1998, in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

## **Use of Computer-Processed Data**

We relied on DLA computer-processed data contained in the Automated Best Value System, Customer Depot Complaints System, and the Standard Automated Material Management System. We did not establish the reliability of the data because it was not within the scope of the audit. However, we did examine the computer-processed data to verify that the information included in the data fields and records we requested. We also determined that the records contained reliable information on national stock number, control number, and contract number.

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## **Appendix B. Prior Audits and Other Reviews**

**GAO Report No. 98-118, "Federal Prison Industries, Delivery Performance Is Improving But Problems Remain,"** June 1998, stated FPI delivery performance is improving – upward trend in the latter part of FY 1997. However, Federal Prison Industries, Inc. fell short of meeting its goal of 90 percent on time delivery in FY 1997.

**GAO Report No. 98-50, "Federal Prison Industries, Inc. Limited Data Available on Customer Satisfaction,"** March 1998, stated that Federal Prison Industries, Inc. lacks sufficient data on how Federal customers view their supplies and services. Federal Prison Industries, Inc. concurred with the General Accounting Office recommendation to develop a database to measure customer satisfaction.

**IG, DoD Report No. 93-066, "Recoupments for Quality Defects,"** March 10, 1993 stated that the DLA supply centers did not perform complete quality assurance investigations because quality assurance specialists frequently curtailed Quality Deficiency Report investigations without validating quality deficiencies through the supplier. As a result of the recommendations, DLA issued a policy memorandum requiring quality assurance specialists to meet certain objectives in a quality deficiency investigation. Also, DLA implemented procedures to perform laboratory tests as a means to support a quality deficiency investigation.

**IG, DoD Report No. 92-005, "DoD Procurements from Federal Prison Industries, Inc.,"** October 11, 1991 found that prices paid for electronic and electrical cables from UNICOR often exceeded costs and negotiated profits. As a result of the recommendations, the Department of the Army requested a voluntary refund from UNICOR. The Defense Logistics Agency Directive 4105.1, subpart 8.6 "Acquisition from Federal Prison Industries, Inc." was developed as supplemental guidance. The Director of Defense Procurement examined the reasonableness of UNICOR profits on individual contracts.

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## Appendix C. Senator Levin's Questions

**Question 1. How do the prices of FPI supplies and services compare to the prices for comparable supplies and services purchased from the commercial sector pursuant to competitive procedures?**

In a majority of purchases, the price of FPI supplies compares favorably with the price for the same supplies purchased from the commercial sector pursuant to competitive procedures. Based on comparisons of unit prices for the same items, the unit price paid to FPI was greater than the commercial sector unit price 20 percent of the time, lower than the commercial sector prices 78 percent of the time, and the same price 2 percent of the time. Appendix F compares FPI and commercial vendor unit prices.

**Methodology for Price Comparisons.** We asked the DLA supply centers to provide us with selected contract information for each contract awarded to FPI. We asked for the same information about contracts with commercial vendors for the same supply item. The definition of the "same supply item" compared either items with the same Federal stock number, or clothing and textile items from the same supply group code. FPI defines a supply item much more broadly, sometimes to mean a supply class or Federal Stock Class. Our definition was limited to the same item, such as long sleeve shirt, not a class of supply items.

We limited comparisons to contracts awarded after September 30, 1995 [FY 96 forward]. We limited the contracts to this period primarily to avoid having to adjust the unit prices for the effects of inflation, and to evaluate current performance rather than past performance. The overall producer price index (PPI) for calendar 1996 and 1997 was relatively constant. The PPI is often used by contracting officers for performing price analysis. While the normal method for price analysis is to use an industry or commodity index rather than the general index, the use of the general index is adequate for our comparisons.

We matched the information by supply item and compared unit prices to determine whether the price paid to FPI was less or greater than the price paid to commercial sector vendors for the same supply item. After September 1995, not all FPI contracts awarded had a matching commercial contract and some items had multiple awards for either or both FPI and commercial contracts. Since some FPI contracts did not have a match, while others had more than one match, the count of contracts that match is less than the number of supply item matches because some contracts match more than one time. We did not evaluate whether the center purchased an item exclusively from FPI at a price that exceeded current market price.

**Question 2. How do the quality and timeliness of FPI supplies and services compare to the quality and timeliness of comparable supplies and services purchased from the commercial sector pursuant to competitive procedures?**

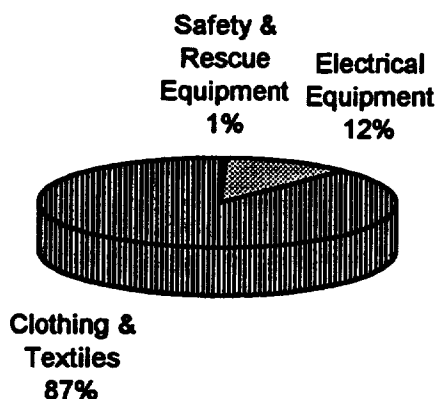
## **Appendix C. Senator Levin's Questions**

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The quality of FPI supplies compares favorably to commercial supplies for purchases made by DLA. In comparing FPI and commercial supplies for like items, both had a quality defect rate of less than a tenth of one percent for the total items reported on product quality deficiency reports.

All the PQDRs submitted were Category II quality deficiencies that will not cause death, injury, severe occupational illness, loss or major damage to a weapons system, or result in a production line stoppage. DLA supply centers quality assurance and contract personnel stated that while FPI supply quality was a problem in the past, in recent years the FPI supply quality has been good and compares favorably to like supply items purchased from the commercial sector. The proportion of defective supply items to the total items purchased is approximately the same for both FPI and the commercial sector for the same supply items.

**Methodology for Quality Review.** During October 1, 1994 through September 30, 1997, DLA received 337 PQDRs for deficiencies of supply items purchased from FPI. The 337 PQDRs reported 24,915 defective supply items based on a total of 6.2 million items purchased. This represents less than 1 percent of the items purchased that were reported defective by DLA customers.



**Figure C-1. The 337 PQDRs were submitted for these Federal supply classes.**

We grouped the PQDRs by Federal supply class and compared supplies with the same national stock number that was purchased from FPI and commercial vendors. Based on the comparison, there were 27 PQDRs issued against FPI supplies and 82 PQDRs against commercial supplies.

For FPI supplies, the 27 PQDRs reported 46 defective items based on 1.3 million supply items purchased. For commercial vendor supplies, the 82 PQDRs reported 420 defective items based on 12.8 million supply items purchased. In both instances, less than 1 percent of the total supply items purchased were reported defective on PQDRs submitted to DLA supply centers. See Appendix G for item descriptions for PQDRs reported.

**Quality Assurance Representative.** We contacted Defense Contract Management Command quality assurance representatives who perform source inspections at prisons that manufacture the supplies reported on the PQDRs. The quality assurance representatives reported that FPI quality is excellent compared to commercial vendors who manufacture supplies for DoD. Also, FPI is very responsive when a source inspection identifies a material deficiency. The quality assurance representatives stated that FPI currently has a 2 percent defective rate in source inspection.

**Timeliness.** For DSC Philadelphia clothing and textile purchases, FPI contract deliveries were untimely and compared unfavorably with like supply items purchased from the commercial sector. For the contracts reviewed, FPI delivery delinquency rate was 29 percent and the commercial vendors' delivery delinquency rate was 18 percent for like supply items such as extended cold weather trouser, battle dress uniform, and body armor.

For the DSC Richmond and Columbus Automated Best Value System, we compared the contract delivery performance of FPI and commercial vendors for Federal supply classes. For DSC Richmond, FPI had an average on time delivery score of 51 percent compared to an average on time delivery score of 70 percent for the center's vendors for all the Federal supply classes. For DSC Columbus FPI had an average on time delivery score of 76 percent compared to an average on time delivery score of 69 percent for the center's vendors for all the Federal supply classes. A delivery score of 100 percent (50 points) would represent a contractor with perfect on time delivery performance.

**Methodology for Clothing and Textile Timelines.** We reviewed 17 FPI contracts and 17 commercial contracts awarded during FY 1996 through FY 1997 for like supply items. We used data from, "DPSC Form 420, Contract Status Record," to compute the delinquency rate and average number of days late. A supply item is considered delinquent when the contractor did not deliver all specified items by the end of the scheduled delivery month. For example, if the schedule requires the contractor to deliver 25 shirts by the end of the month and the contractor has delivered 19 shirts at the end of the month, they are delinquent. The delinquency rate is determined by dividing the number of delinquent items by the total number of items for delivery. A contract supply item is not delinquent if

## **Appendix C. Senator Levin's Questions**

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it is caused by a Government delay. Our analysis was based on the methodology used in the May 1996 Defense Personnel Support Center's, "Analysis of UNICOR and NIB/NISH Contracting Practices on Clothing and Textiles Readiness."

The 17 FPI contracts had 191 scheduled deliveries. Of the 191 deliveries, FPI was delinquent on 11 contracts for 56 deliveries. Each FPI delinquency averaged 17.9 days late. The 17 commercial contracts had 184 scheduled deliveries. Of the 184 deliveries, commercial vendors were delinquent on 7 contracts for 34 deliveries. Each commercial delinquency averaged 5.3 days late. Appendix H compares the delinquent FPI and commercial contracts.

**Methodology of Using Automated Best Value System Timeliness.** We compared the delivery performance of 17 FPI facilities and those commercial vendors that manufacture 15 Federal supply classes of products for DSC Richmond. We also compared the delivery performance of 4 FPI facilities and those vendors that manufacture 7 Federal supply classes for DSC Columbus. We conducted this product comparison using information from the Automated Best Value System.

The Automated Best Value System is an automated system that collects a vendor's past performance data and translates it into a numeric score. The contracting officer then uses the scores as an additional evaluation factor when making best value contract award decisions.

The Automated Best Value System assigns a score for performance in each Federal supply class and for performance in all Federal supply classes at DSC Richmond and Columbus (center score). A contractor has a score for each Federal supply class that they manufacture, but will have only one center score, which is an average of the contractor's Federal supply class scores. The Automated Best Value System scores range from 0 to a perfect score of 100 points, 50 points for quality and 50 points for delivery timeliness.

By comparing the DSC Richmond FPI delivery scores with the overall vendors' scores for Federal supply classes, we concluded that FPI has a lower delivery score than the collective score for all vendors. For the 15 Federal supply classes, the average delivery score for FPI is 51 percent, while the average center's overall vendors' score is 70 percent for all Federal supply classes. For DSC Columbus, our comparison showed that FPI had a higher on time delivery score than the collective score for all vendors. For the 7 Federal supply classes, the average delivery score for FPI is 76 percent compared to the center's overall vendors score of 69 percent for all Federal supply classes. Contractors with high ratings represent a lower performance risk.

DSC Richmond and Columbus use the Automated Best Value System to record FPI past performance scores for the Federal supply classes. However, contracting officials do not use the past performance information to award contracts to FPI because of its mandatory source status. FAR 42.15 "Contractor Performance" exempts agencies on evaluating past performance for contracts awarded to FPI.

The Automated Best Value System scores are available for FPI to review, however, FPI has not used the data as a customer satisfaction indicator. The Automated Best Value System relies on vendors to ensure data integrity in the system by reviewing the scores and challenging the data if they believe the scores are incorrect.

**Question 3. Does the Department have appropriate procedures in place to determine whether FPI supplies and services are of appropriate "quality, character and suitability" and are purchased at "not to exceed current market prices," as required by law?**

We found that the DLA does have appropriate procedures to determine if FPI supplies and services are of appropriate quality, character, and suitability. The DLA does not have appropriate procedures for ensuring that its purchases from FPI are at "not to exceed current market prices."

The Defense Contract Management Command quality assurance representatives perform source inspections at the FPI prison facilities to identify quality problems before FPI supplies are shipped to DoD customers.

If the customer receives defective items, DLA has a PQDR program that allows customers to report deficiencies and receive consideration (repair, replacement or credit) for defective items. The PQDR program includes a system for accumulating supply quality deficiency data. With this system, the DLA can provide for the initial reporting, cause correction, and status accounting of individual supply quality deficiencies and identify problems, trends, and recurring deficiencies.

Generally, the contracts reviewed were for supplies manufactured to Government specifications. We found that FPI supplies manufactured for DLA are of appropriate character and suitability because FPI follows the specifications provided by the DoD.

The need for additional procedures to ensure that the Department's purchases from FPI are at not to exceed the current market prices is discussed in the report's Finding B. Besides discussing the need for additional procedures in this finding, we also make recommendations concerning what the Department should do to ensure that its purchases are made at not to exceed current market prices.

**Question 4. Does the Department have appropriate procedures in place to ensure that contracting officials seek waiver of the requirement to purchase supplies and services from FPI in cases where those supplies and services are overpriced or otherwise unsuitable? As a part of this review, it would be extremely helpful if you would collect basic information on the total number and dollar value of DoD purchases from FPI; the number and dollar value of purchases for which waivers should have been sought, based on applicable**

**standards; the number and dollar value of purchases for which waivers were, in fact, sought; and the number and dollar value of purchases for which waivers were granted?**

**Waiver Procedures.** Except for DLA, DoD does not have Department wide guidance that provides procedures for submitting waivers to FPI and appealing waiver denials. The Defense Logistics Agency Directive, 4105.1, subpart 8.6, "Acquisition From Federal Prison Industries, Inc.," provides minimum guidance on waiver process procedures with FPI. DLA supply centers have supplemented DLAD 4105.1 guidance on waiver processes in which each center's Small Business Office is the focal point for FPI disputes and issues. DLA centers can request waivers from FPI via mail, e-mail, facsimile, telephone, and internet. Waivers are primarily due to:

- FPI material delivery time;
- FPI technical specifications and requirements;
- lower quoted prices from commercial sector vendors;
- FPI production limitations; and
- general waivers on electrical, metal, clothing and textile supplies.

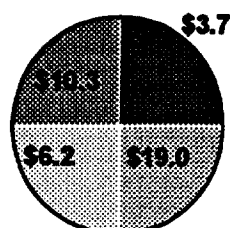
**DoD Waiver Data.** DoD does not have a Department-wide waiver database. DLA centers do not maintain extensive data on the number of waivers requested, approved, and denied and the associated waiver dollar value. DSC Philadelphia's Small Business Counseling Office maintains the most extensive waiver database for a DLA center. The database includes the number and supply type (clothing, textiles, furniture, medical apparel) of waivers approved by FPI for the center. DSC Richmond and DSC Columbus do not maintain a waiver database but they do have file copies of the waiver requests but not the disposition of the waiver request.

**FPI Waiver Data.** Because DoD has no Department-wide waiver data, we requested that FPI Headquarters provide waiver data for DoD for FY 1997. In January 1998, the FPI Customer Service Center in Lexington, Kentucky, provided summary DoD waiver data. The data shows that FPI granted \$191 million waivers and denied \$39 million waiver requests for DoD. The data represented the Military Departments (Army, Navy/Marine Corps, and Air Force) and "DoD Other" (DoD agencies, including DLA).



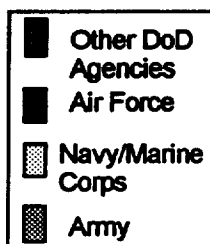
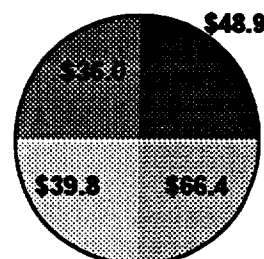
**FY 1997 FPI Denied Waivers**

(\$39.2 million)



**FY 1997 FPI Approved Waivers**

(\$191.1 million)



**Figure C-2. The DoD waiver data is shown by these graphs.**

**Purchase Information.** We did not acquire total DoD purchases of FPI supplies because DoD does not maintain annual purchase data. There is procurement data on the DD350, "Individual Contracting Action Report;" however, this does not include contracts valued at less than \$25,000. In additions, we do not have Department wide information for the FPI waiver data related questions. Specifically, we cannot address the number and dollar value of purchases in which waivers should have been submitted based on FAR 8.6 guidance for customer disputes related to price, quality, character, or suitability of FPI supplies; and the number and dollar value of purchases in which waivers were submitted and approved by FPI. For FY 1996 and 1997, we relied on FPI waiver data for approved and also denied Department waiver requests.

**Comparison of DLA and FPI Waiver Data.** Based on our review, we have concluded that the FY 1997 FPI waiver data for "DoD Other" (which includes DLA) is understated. We compared data from DLA centers at Richmond and Philadelphia with FPI data from the Customer Service Center in Lexington, Kentucky. The DSC Philadelphia waiver data listed 27 FPI approved waivers; however, the FPI data listed only 10 approved waivers for Philadelphia. The DSC Richmond had 130 waiver approvals for electronic supplies; however, the FPI data had no waivers listed for Richmond. We discussed our waiver data base comparison with FPI headquarters officials. They agreed that the FPI waiver data is understated due to data inputting between commodity groups at FPI headquarters and Lexington.

**Methodology on Reviewing Waiver Procedures and Data.** We reviewed DoD Directives and Instructions relating to FPI. We interviewed officials from the Office of the Secretary of Defense, Small and Disadvantaged Business Utilization. We obtained and reviewed DLA guidance, and we interviewed personnel from the material management office at DLA. We also interviewed DLA center officials

## **Appendix C. Senator Levin's Questions**

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from the Small Business and procurement offices. We reviewed waiver documentation at DLA centers, to include contract files, waiver data, and DSC Philadelphia waiver database.

We interviewed the FPI Ombudsman to discuss the appeal process for denied waivers. We obtained FPI waiver guidance, waiver data, and waiver appeals information. We also interviewed the FPI Director of Sales, Marketing and Customer Service and officials from the Electronic Commodity Group.

## Appendix D. Department of Justice Opinion



U. S. Department of Justice

Office of Legal Counsel

Office of the  
Assistant Attorney General

Washington, D.C. 20530

September 13, 1993

MEMORANDUM FOR KATHLEEN M. HAWK  
Director, Federal Bureau of Prisons  
Commissioner, Federal Prison Industries

Re: Application of the Federal Acquisition Regulations  
to Procurement from Federal Prison Industries

This memorandum responds to the request of the Bureau of Prisons for our opinion on whether certain federal procurement statutes and provisions of the Federal Acquisition Regulation (FAR) apply to Federal Prison Industries, Inc. (FPI). Specifically, we have been asked: (1) whether FPI has the ultimate authority, subject to FPI's authorizing legislation, to decide the price at which to sell its goods to federal government customers; (2) whether FPI must submit certified cost and pricing data to federal agencies pursuant to 10 U.S.C. § 2306a and FAR 15.8; and (3) whether FPI may estimate the current market price of its goods by reference to the price of the same or similar goods more than one year in the past.

We conclude that the provisions of the FAR governing the submission of certified cost or pricing information, the calculation of a "reasonable price" other than market price, and the general FAR procedures for resolving pricing disputes do not apply to FPI. We also conclude that the requirements of 10 U.S.C. § 2306a do not apply to FPI. We express no opinion on FPI's individual calculations of the current market price of its goods by reference to the actual price of the same or similar goods in the past. We conclude, however, that FPI may use any method that reliably estimates current market prices, subject to dispute by potential customers prior to purchase and arbitration under 18 U.S.C. § 4124(b).

### I.

FPI, also referred to as UNICOR, is a self-supporting, wholly owned government corporation.<sup>1</sup> FPI operates pursuant to a

<sup>1</sup> See 31 U.S.C. § 9101(3).

statutory mandate to "provide employment for the greatest number of those inmates in the United States penal and correctional institutions who are eligible to work as is reasonably possible. . . ." 18 U.S.C. § 4122(b)(1). In fulfilling that mandate, FPI's authorizing statute requires that it diversify operations so "that no single private industry shall be forced to bear an undue burden of competition from the products of the prison work-shops, and to reduce to a minimum competition with private industry or free labor." *Id.* See also § 4122(b)(3) (FPI "shall diversify its products so that its sales are distributed among its industries as broadly as possible"). The statute also requires that FPI focus its operations on labor-intensive manufacturing. § 4122(b)(2).

FPI makes a variety of products using paid prison labor. FPI goods that are not used by the federal prisons may be sold only to "the departments or agencies of the United States." § 4122(a). Although FPI is prohibited from selling to the public in competition with private enterprise, it has been granted a preference in sales to the United States. Federal departments, agencies, and institutions must "purchase [from FPI,] at not to exceed the current market prices, such [FPI] products . . . as meet their requirements and may be available." § 4124(a). All disputes about the price, quality, character, or suitability of FPI's products are expressly committed to an arbitration board. § 4124(b). The decision of the arbitration board is "final and binding upon all parties." *Id.*

The mandatory preference granted FPI is an exception to the rules that normally govern the way goods are procured by the United States. Typically, federal procurement is governed by FAR, 48 C.F.R. §§ 1.000-51.205, a detailed set of procedures and forms promulgated pursuant to the Office of Federal Procurement Policy Act of 1974 (Procurement Act), 41 U.S.C. §§ 401-424. The Procurement Act embodies a number of policy goals, including "promoting full and open competition; . . . promoting the development of simplified uniform procurement processes; . . . [and] promoting fair dealings and equitable relationships with the private sector." 41 U.S.C. § 401.

The Office of Federal Procurement Policy (OFPP), created by the Procurement Act, is charged with providing overall direction of procurement policy and leading the development of procurement systems for the Executive agencies. 41 U.S.C. § 405. Under the guidance of the OFPP Administrator, two separate councils, representative of defense and civilian agencies, respectively, maintain FAR's uniform standards and procedures. 48 C.F.R. § 1.201. The Administrator of OFPP, however, retains authority to prescribe government-wide procurement policies through FAR "with due regard for applicable laws and the program activities

of the executive agencies."<sup>1</sup> 41 U.S.C. § 405(a), (b). The OFFP Administrator, with the concurrence of the Director of the Office of Management and Budget, may rescind any government-wide regulation or any rule or regulation of an executive agency relating to procurement that the Administrator determines is inconsistent with the policies of the Procurement Act or the FAR. 41 U.S.C. § 405(f).

II.

On October 11, 1991, the Inspector General of the Department of Defense (Inspector General) issued an audit report entitled "DoD Procurement from Federal Prison Industries." Report No. 92-005 (Audit Report). The Inspector General examined a number of procurement contracts pursuant to which the Department of Defense (DoD) purchased electronic and electrical cable from FPI between 1984 and 1990. The Audit Report concluded that DoD did not comply with the FAR in awarding the audited contracts to FPI and that, as a consequence, DoD was overcharged on a substantial number of the sampled contracts.

In particular, the Audit Report found that the FAR was violated when DoD failed to obtain, and FPI failed to provide, certified cost and pricing data for the cable products sold. Pursuant to FAR 15.802, 10 U.S.C. § 2306a, and 41 U.S.C. § 254(d), Executive agencies generally must require a contractor to submit and certify cost or pricing data.<sup>2</sup> See also 48 C.F.R. §§ 15.804-2, 15.804-4. The contractor's cost and pricing data is used by the procuring agency to negotiate a "reasonable price" for the goods to be purchased. 48 C.F.R. §§ 15.802(b)(1); 15.804-1(a). Although the concept of "reasonable price" is flexible, 48 C.F.R. § 15.805, the Inspector General, with support in the regulations, interprets the term to mean a price reflecting allowable costs of production plus a reasonable profit. See 48 C.F.R. §§ 15.805-3, 31.201 (reasonable cost),

<sup>2</sup> The Procurement Act defines the term "executive agency" to include "a wholly owned Government corporation fully subject to the provisions of chapter 91 of title 31." 41 U.S.C. § 403(1)(D). Because FPI is "a wholly owned Government corporation" subject to the provision of chapter 91 of title 31, see 31 U.S.C. §§ 9101-9106, 9109, it is an "executive agency" for purposes of the Procurement Act.

<sup>3</sup> There are several exceptions to the requirement to submit certified pricing data. One exception is when the price of the goods to be purchased is "set by law or regulation." 48 C.F.R. § 15.804-3(a)(3). Since we conclude that FAR 15.8 is not applicable to procurement contracts with FPI, we do not address the question of whether FPI's prices are set by law or regulation within the meaning of FAR 15.8.

15.9 (profit). Both the FAR and the relevant acquisition related statutes require the inclusion of clauses in the final negotiated procurement contract that provide for "reduction of the contract price by any significant amounts that such price was increased because of submission of . . . defective cost or pricing data." 48 C.F.R. §§ 15.802(a), 15.804-8, 52.215-22, 52.215-24.

The Audit Report also found fault with FPI's internal accounting procedures pursuant to which certified cost and pricing data were developed. In particular, the Audit Report concluded that FPI used erroneous empirical data in estimating its costs, and did not comply with the requirements for estimating systems set out in FAR 15.811. The Audit Report also concluded that FPI's cost accumulation procedures were inadequate in that they failed to segregate costs on each contract and failed to distinguish direct and indirect costs properly. See 48 C.F.R. § 31.201. Finally, Appendix I of the Report criticized FPI's method of estimating the market price of its goods. It attacked the age of the database, its validity even when current, and FPI's method of adjusting the data by simply applying an annual inflation factor of four percent.

FPI answered generally by stating that, as a wholly-owned government corporation operating in a special procurement environment created by its authorizing legislation, it is not subject to the FAR requirements relied on in the Audit Report when it is dealing with DoD. It is FPI's position that FAR 8.6 treats procurement from FPI specially, and that the normal regulations applicable to the procurement from the private sector (the standard terms) do not apply.<sup>4</sup>

### III.

In determining whether the standard provisions of the FAR govern purchases from FPI, we must interpret the relevant portions of the Procurement Act, the FAR, and FPI's authorizing legislation. For the reasons set forth below, we believe that

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<sup>4</sup> The OFPP Administrator, whose acquisition regulations are the subject of this opinion, sent a letter to this Office stating that OFPP has not "taken a position on the general applicability of the provisions of the Federal Acquisition Regulation (FAR) to the acquisition of goods and services from FPI." Letter from Allan V. Burman, Administrator, Office of Federal Procurement Policy, to John C. Harrison, Deputy Assistant Attorney General, Office of Legal Counsel (Sept. 21, 1992). Nonetheless, the Administrator stated that he did not believe that the submission of certified cost and pricing data by FPI "is advisable from a public policy standpoint" when current market pricing information is available on analogous products to those purchased from FPI. *Id.*

the correct reading of the relevant statutes and regulations, taken as a whole, is that FPI is not covered by the FAR's standard terms, and instead, FPI must be treated specially under its authorizing legislation and FAR subpart 8.6.

Initially, we note that neither the Procurement Act nor the FAR states that the standard provisions of the FAR apply to contracting with FPI. Instead, both the Procurement Act and the FAR contain strong evidence to suggest that the standard provisions of the FAR were not intended to apply to FPI. Section 405(a) of the Procurement Act states that the FAR policies should be prescribed (and, by implication, applied) "with due regard for applicable laws and the program activities of the executive agencies. . . ." 41 U.S.C. § 405(a). In short, the Procurement Act itself directs that, where possible, the FAR should not conflict with specialized procurement laws applicable to an Executive agency such as FPI. Thus, if the FAR were silent regarding its application to FPI, there still would be reason to conclude that the standard provisions of the FAR do not apply to FPI, because the scheme set up by FPI's authorizing legislation is simply not consistent with the application of the FAR provisions governing routine procurement from the private sector.

The FAR, however, is not silent regarding its application to FPI. Indeed, FAR subpart 8.6 contains special provisions relating to acquisition from FPI, including special procedures to resolve disputes regarding the price, quality, and character of FPI products.

With respect to pricing, we agree with the Inspector General that FPI's statutory command not to "exceed current market prices" does not in itself say whether the FAR may impose additional price limits. But other aspects of FPI's authorizing legislation, coupled with the special treatment of FPI in the FAR, indicate that the FAR should not be construed to interfere with FPI's operations pursuant to its authorizing legislation, including the setting of prices that do not exceed market prices. Subpart 8.6 of the FAR governs "Acquisition From Federal Prison Industries, Inc." 48 C.F.R. § 8.6. These provisions provide implicit and explicit evidence that purchases from FPI were not intended to be governed by the standard FAR terms. Most directly, section 8.602 provides that:

Agencies shall purchase required supplies of the classes listed in the Schedule of Products made in Federal Penal and Correctional Institutions . . . at prices not to exceed current market prices, using the procedures of this subpart. (emphasis added).

Moreover, the procedures prescribed in the subpart strongly imply that an FPI price not exceeding the market price may be accepted without regard to the FAR's standard terms:

When the contracting officer believes that the FPI price exceeds the market price, the matter may be referred to the cognizant product divisions identified in [FPI's Product] Schedule or to the FPI Washington office for resolution.

48 C.F.R. § 8.604(c) (emphasis added).<sup>3</sup> This language, which does not compel action, only initiates further negotiation with respect to price when the FPI price exceeds the market price. The threshold issue is whether FPI's price exceeds the market price, not whether it exceeds some independent formula of allowable costs plus profit.<sup>3</sup>

A further example of FPI's special status within the FAR framework lies in the fact that, because DoD must meet its needs for goods available from FPI through FPI (at prices "not to exceed current market prices"), DoD lacks its most basic remedy under the FAR when it deals with FPI. If a private sector entity chooses not to comply with the FAR, the federal government normally may not buy from that entity. In contrast, DoD lacks the necessary contracting freedom to make FPI accept the FAR's constraints. Nothing in FPI's charter, nor in the FAR, suggests that governmental entities may ignore the mandatory priority simply because FPI will not accede to all requested contract terms during negotiation. Consequently, if FPI refuses to provide certified pricing data or refuses to reduce its price to what the DoD considers a "reasonable price," DoD still must abide by the mandatory priority and buy available goods from FPI.

Finally, the pertinent statutory and regulatory framework treats FPI transactions separately from those with private sector entities with respect to dispute resolution. Subpart 33.2 of the FAR sets out regulations governing "Disputes and Appeals" in accordance with the Contract Disputes Act of 1978 (Disputes Act), 41 U.S.C. §§ 601-613. Both the Disputes Act and the associated FAR regulations place initial jurisdiction to resolve disputes relating to a government contract with the Contracting Officer, with appeal to a Board of Contract Appeals, and eventual review in the United States Claims Court. See 41 U.S.C. §§ 605, 606, 609; 48 C.F.R. § 33.210. In contrast, FPI's authorizing legislation expressly commits all disputes as to the "price, quality, character or suitability" of FPI products to a special arbitration board, and makes the findings of that board "binding

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<sup>3</sup> Moreover, the FAR expressly states that clearances to buy from a source other than FPI normally will not be granted solely because goods are available elsewhere at a lower cost. 48 C.F.R. § 8.605(b).



upon all parties." 18 U.S.C. § 4124(b).<sup>6</sup> In recognition of this law, subpart 8.6 of the FAR contains provisions that expressly preserve FPI's dispute resolution procedure. 48 C.F.R. § 8.605(c) ("Disputes regarding price, quality, character, or suitability of products produced by FPI are subject to arbitration as specified in 18 U.S.C. 4124").

Overall, the statutory and regulatory structure of the FAR and the FPI establish separate procurement regimes for two decidedly different procurement programs. The bulk of federal procurement, accomplished in the free market by contracts with entities in the private sector, is subject to the general terms of the FAR. With such contracts, the FAR promotes the many goals of the Procurement Act such as uniformity, fair price competition, procurement at the lowest reasonable cost, and the elimination of fraud, waste, and abuse.<sup>7</sup> A small portion of federal procurement is through FPI, a government corporation, with a statutory preference requiring federal entities to buy products from FPI to the extent that FPI has them available. With FPI contracts, the FAR defers to the public policy goals of FPI--providing work and training for inmates in our federal prisons. Accordingly, given the separate, distinct nature of the

<sup>6</sup> The dispute resolution process imposed by the Disputes Act and the FAR's standard terms is not only inconsistent with FPI's charter, but might not apply to FPI on its own terms. The Disputes Act is written to deal with claims between the "government" and a "contractor." See 41 U.S.C. § 605(a). The Act defines "contractor" as "a party to a Government contract other than the Government." § 601(4). FPI is wholly owned by the government, run by government officials, and Congress has characterized sales by FPI as "intergovernmental transfers." § 4126(d). It seems likely, therefore, that FPI would have to be treated as the "Government" for purposes of the Disputes Act. Thus, the Disputes Act provisions designed to resolve disagreements between the government and private contractors would not apply to contracts between government agencies and FPI. Similarly, at least one court has held that the Disputes Act does not apply to contracts where the government has contracted to provide goods and services, rather than to buy them. See *Rider v. United States*, 7 Cl. Ct. 770, *aff'd*, 790 F.2d 91 (1985) (contract for delivery of third class mail with the Postal Service). Contracts between FPI and other government entities might be characterized as contracts primarily for the government to provide goods and, therefore, exempted from the Act.

<sup>7</sup> Many of the FAR's policy goals simply do not apply to purchases from FPI, which is a further indication that FAR does not subject FPI to its standard terms. For example, the FAR's goal of increasing competition cannot be promoted if goods must be bought from FPI.

FPI and the FAR programs, and the language of the pertinent parts of the Procurement Act, the FAR, and the FPI authorizing legislation, we conclude that the general terms of the FAR do not apply to FPI.

IV.

With the central issue decided, we now address several specific arguments the Inspector General has raised against FPI's position in this dispute. First, the Inspector General argues that if DoD pays a market price which is higher than a price based on cost of production and reasonable profit, then DoD would be subsidizing FPI. In this regard, the Inspector General appears to be arguing that FPI should be limited to making a fixed profit on each item it sells based on the cost of its production, and that any profit above this level unreasonably reduces the budget of the DoD.

As a factual matter, FPI points out some of the problems in using the FAR formulae to estimate its true costs of production, especially given FPI's unique statutory obligations. Letter from J. Michael Quinlan, Director, Bureau of Prisons, to Timothy E. Flanagan, Acting Assistant Attorney General, Office of Legal Counsel (Nov. 5, 1991). For example, the Inspector General defined FPI's labor cost as \$.23 to \$1.15 per hour. Although FPI has access to low cost labor because it employs prisoners, it also accepts a variety of special burdens, security costs, and restrictions because of the nature of its business. By statute, FPI also is restricted in the types of products it may produce and even how much of a given product it may produce. 18 U.S.C. § 4122(b)(2)-(4).<sup>8</sup> Perhaps for these reasons, both the FAR and FPI's charter link FPI prices to market prices, established by competition, thereby obviating the need for a calculation of FPI's true costs of production.

In any event, the existence or non-existence of a "subsidy" is a policy question that does not affect the legal issue of what price FPI is authorized to charge and what price DoD must pay when it purchases from FPI. FPI's statute provides that it may charge up to the market price regardless of its costs of production or its potential profit.<sup>9</sup> 18 U.S.C. § 4142(a). Moreover, it is consistent with congressional intent for FPI to run a profit, and there is no limit on its profit on any

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<sup>8</sup> Under its charter, FPI must specialize in labor intensive industry, must diversify "as broadly as possible," and must "avoid capturing more than a reasonable share of the market." *Id.*

<sup>9</sup> This is also consistent with FAR subpart 8.6, which does not require cost-based price estimation.

individual product as long as FPI's prices do not exceed market prices. By statute, FPI is self-supporting and relies on its profits to expand and to otherwise achieve its statutory goal of providing employment and training to the "greatest number of those inmates . . . as is reasonably possible." § 4122(b)(1). Congress also provided that any money under the control of FPI that is not expended by the corporation to achieve its employment related statutory obligations are to be deposited and remain in the Treasury of the United States. § 4126. In this way, Congress ensured that any FPI "profit" would redound to the benefit of the United States and to the prisoners rather than to private sector entities.

Next, the Inspector General notes that FPI has a long-standing practice of negotiating contract prices based on cost. The Inspector General also maintains that FPI uses cost data, along with market price information for similar products, when information on current market prices of a particular good is unavailable. Letter from Derek J. Vander Schaaf, Deputy Inspector General, Department of Defense, to Timothy E. Flanigan, Acting Assistant Attorney General, Office of Legal Counsel (Nov. 20, 1991). The Commissioner of FPI agrees that FPI is willing to negotiate prices, although he does not say whether such negotiations are based on cost. Letter from J. Michael Quinlan, Director, Bureau of Prisons, to Timothy E. Flanigan, Acting Assistant Attorney General, Office of Legal Counsel (Nov. 5, 1991). Nevertheless, the fact that FPI apparently has and continues to negotiate prices and may consider the cost of its production has no bearing on whether, as a matter of law, it retains ultimate statutory authority to set its own prices, subject to arbitration.<sup>10</sup>

Finally, the Inspector General argues that, even if 18 U.S.C. § 4124(b) is the only remedy for excessive FPI prices, customers must have certified cost or pricing data under FAR 15.8 or they will be unable to detect unfair prices. This argument assumes, however, that FPI's prices must be based on cost and that FAR 15.8 applies to FPI. As discussed above, neither assumption is correct. Although cost data may have some role in price negotiations, they do not bind FPI to use a cost-plus-profit system to set prices. Moreover, there is no dispute that FPI continues to provide uncertified cost and pricing data to potential customers. FPI customers remain free to challenge FPI

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<sup>10</sup> Although FPI enjoys a mandatory priority, that does not eliminate all room for negotiation. FPI may well wish to accommodate its customers where possible to maintain good business relations and a cooperative spirit.

with their own or FPI's figures when they have reason to believe FPI's prices exceed those set by the market."

V.

The final question posed by FPI is whether it may estimate the market price of its goods by taking the price of the same or similar goods that prevailed more than one year in the past and adjusting that price for inflation. Given our conclusions above, FPI's question, in effect, requests our opinion on whether a particular formula calculates "current market prices" and whether that formula was employed correctly in particular contracts. We decline to render an opinion on these questions.

Neither FPI's authorizing legislation, nor FAR subpart 8.6 gives any specific guidance on how "current market prices" must be determined. Moreover, the only relevant Arbitration Board decision of which we are aware gives no affirmative direction on this issue. That decision states that "cost of production is not current market price," nor is market price necessarily the lowest of competitive bids received, since the bid may have resulted from error, misunderstanding of the specifications, or distress. Excerpt of Findings of Board of Arbitration--Prison Industries, Objection to War Department to Price of Brooms, Feb. 7, 1931. But the Board opinion gives no affirmative direction. Cf. 48 C.F.R. § 15.805-2 (recognizing a variety of methods for estimating a "reasonable price").

We believe the term "current market price" should be understood to convey its common economic meaning, which reflects the dynamic of supply and demand in a competitive market."<sup>2</sup> We

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" In its submission to this Office, FPI states that:

FPI does not dispute that the DoD has authority to audit its cost estimation and accumulation system. However, as with pricing policy, FPI does not believe that the FAR policies and procedures for submission of cost data are necessarily controlling (including a provision for interest and penalty payments); however, FPI acknowledges that the DoD IG has identified problems that are significant in its cost accumulation system and FPI is committed to rectifying these problems . . . with assistance (from DoD).

Id. at 3-4 (footnote omitted).

<sup>2</sup> See generally Milton M. Shapiro, Foundations of the Market-Price System 179-233 (1985); Edwin Mansfield, Microeconomics: Theory and Applications (3d ed. 1979); Wayne C. Curtis, Microeconomic Concepts for Attorneys: A reference Guide

hesitate, however, to say what methodologies may or may not be used to determine the market price of certain goods at a certain time. Several approaches may be appropriate including, at times, a cost-plus-profit approach.

Similarly, we decline to comment on the Audit Report's criticism of the accuracy of FPI's underlying price data.<sup>13</sup> If market price is to be estimated by adjusting a prior price, certainly that prior price must be valid and accurate and the adjustment must be arithmetically sound. But these challenges raised by the Inspector General to the validity and accuracy of FPI's data and calculations appear to be largely empirical rather than legal.

Questions about the accuracy and validity of base prices, like the issue of what methods are suitable for calculating market prices, are probably best resolved in future contract negotiations by discussions between the parties or, if necessary, by resort to the Arbitration Board.

VI.


In summary, we determine that the provisions of the FAR governing the submission of certified cost or pricing information, the calculation of a "reasonable price" other than market price, and the general FAR procedures for resolving pricing disputes do not apply to FPI. We also conclude that the requirements of 10 U.S.C. § 2306a do not apply to FPI. We express no opinion on FPI's individual calculations of the current market price of its goods by reference to the actual price of the same or similar goods in the past. We conclude, however, that FPI may use any method that reliably estimates current market prices, subject to dispute by potential customers prior to purchase and arbitration under 18 U.S.C. § 4124(b).

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(1984).

<sup>13</sup> Appendix I at 43-45. The body of the Inspector General's Audit Report does not discuss FPI's market price calculations, probably because the report concluded that FPI's prices were governed by the FAR's provisions for determining a "reasonable price." The factual accuracy of FPI's records of prior non-FPI market prices, and the validity of its adjustment formula on the audited contracts, were apparently only reviewed in response to FPI's comments on a draft of the Audit Report.

Please let us know if we may be of further assistance.

  
Walter Dellinger  
Acting Assistant Attorney General  
Office of Legal Counsel

cc: Honorable Derek J. Vander Schaaf  
Deputy Inspector General  
Department of Defense

Honorable Allan V. Burman  
Administrator  
Office of Federal Procurement Policy

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## Appendix E. FAR Guidance for Commercial Contracts

While not applicable to purchases from FPI [see Finding A], FAR 15.402, "Pricing policy," provides guidance and an order of preference for contracting officers in determining the type of information required when negotiating prices for supplies and services.

### Contracting officers shall--

(a) Purchase supplies and services from responsible sources at fair and reasonable prices. In establishing the reasonableness of the offered prices, the contracting officer shall not obtain more information than is necessary. To the extent that cost or pricing data are not required by 15.403-4, the contracting officer shall generally use the following order of preference in determining the type of information required:

(1) No additional information from the offeror, if the price is based on adequate price competition, except as provided by 15.403-3(b).

(2) Information other than cost or pricing data:

(i) Information related to prices (e.g., established catalog or market prices or previous contract prices), relying first on information available within the Government; second, on information obtained from sources other than the offeror; and, if necessary, on information obtained from the offeror. When obtaining information from the offeror is necessary, unless an exception under 15.403-1(b)(1) or (2) applies, such information submitted by the offeror shall include, at a minimum, appropriate information on the prices at which the same or similar items have been sold previously, adequate for evaluating the reasonableness of the price.

(ii) Cost information, that does not meet the definition of cost or pricing data at 15.401.

(3) *Cost or pricing data.* The contracting officer should use every means available to ascertain whether a fair and reasonable price can be determined before requesting cost or pricing data. Contracting officers shall not require unnecessarily the submission of cost or pricing data, because it leads to increased proposal preparation costs, generally extends acquisition lead time, and consumes additional contractor and Government resources.

(b) Price each contract separately and independently and not--

(1) Use proposed price reductions under other contracts as an evaluation factor, or

## **Appendix E. FAR Guidance for Commercial Contracts**

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(2) Consider losses or profits realized or anticipated under other contracts.

(c) Not include in a contract price any amount for a specified contingency to the extent that the contract provides for a price adjustment based upon the occurrence of that contingency.

**FAR 15.404-1, "Proposal analysis techniques," provides guidance for contracting officers reviewing contractor proposals.**

(a) General. The objective of proposal analysis is to ensure that the final agreed-to price is fair and reasonable.

(1) The contracting officer is responsible for evaluating the reasonableness of the offered prices. The analytical techniques and procedures described in this subsection may be used, singly or in combination with others, to ensure that the final price is fair and reasonable. The complexity and circumstances of each acquisition should determine the level of detail of the analysis required.

(2) Price analysis shall be used when cost or pricing data are not required (see paragraph (b) of this subsection and 15.404-3).

(3) Cost analysis shall be used to evaluate the reasonableness of individual cost elements when cost or pricing data are required. Price analysis should be used to verify that the overall price offered is fair and reasonable.

(4) Cost analysis may be used to evaluate information other than cost or pricing data to determine cost reasonableness or cost realism.

(5) The contracting officer may request the advice and assistance of other experts to ensure that an appropriate analysis is performed.

**FAR 15.404-1(b), "Price analysis," defines price analysis as the process of examining and evaluating a proposed price without evaluating its separate cost elements and proposed profit. The Government may use various price analysis techniques and procedures to ensure a fair and reasonable price, given the circumstances surrounding the acquisition. Examples of such techniques include, but are not limited to the following:**

(i) Comparison of proposed prices received in response to the solicitation.

(ii) Comparison of previously proposed prices and contract prices with current proposed prices for the same or similar end items, if both the validity of the comparison and the reasonableness of the previous price(s) can be established.



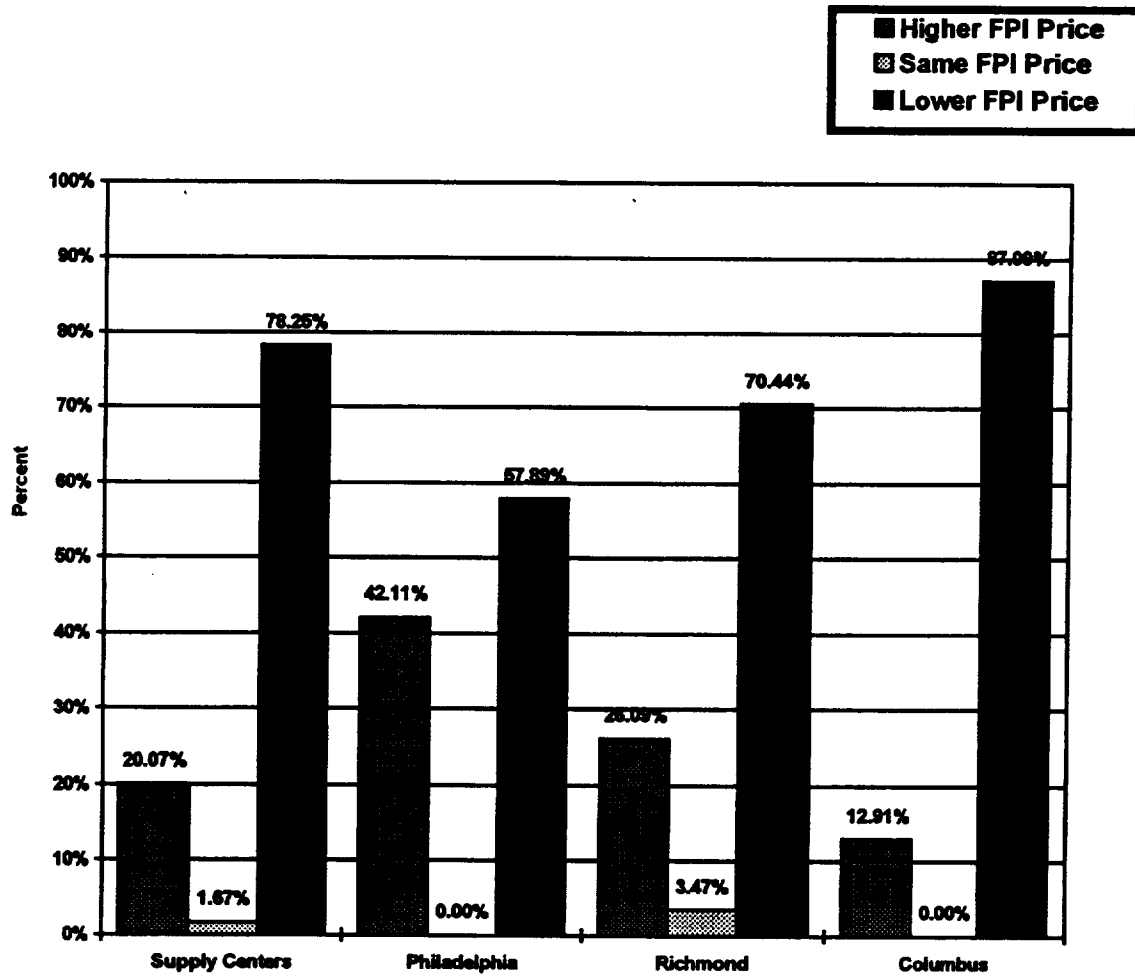
(iii) Use of parametric estimating methods/application of rough yardsticks (such as dollars per pound or per horsepower, or other units) to highlight significant inconsistencies that warrant additional pricing inquiry.

(iv) Comparison with competitive published price lists, published market prices of commodities, similar indexes, and discount or rebate arrangements.

(v) Comparison of proposed prices with independent Government cost estimates.

(vi) Comparison of proposed prices with prices obtained through market research for the same or similar items.

## Appendix F. Comparison of FPI and Commercial Vendor Unit Prices



## Appendix G. Item Description of Product Quality Deficiency Reports

<u>Number of PQDRs</u>	<u>Number of Items</u>	<u>Item Description</u>	<u>Total Replacement Cost</u>
2	2	Bath Towel	\$5.34
3	4	Man's Utility Shirt	42.32
14	17	Man's Utility Trousers	127.16
105	105	Man's Utility Shirt; Flame Retardant	1,136.98
36	48	Man's Shirt	428.12
3	4	Woman's Shirt	45.64
2	2	Woman's Utility Shirt	11.93
4	7	Swimmers' Trunks	33.24
3	4	Camouflage Pattern Coat	55.77
66	17,220	General Purpose Trunks	94,292.66 <sup>1</sup>
38	6,735	Athlete's T-shirt	28,536.73
2	2	Water Canteen Cover	13.69
18	35	Camouflage Trousers	660.66
<u>7</u>	<u>121</u>	Electrical Items	<u>1,696.30</u>
<b>303</b>	<b>24,306</b>		<b>\$127,086.54<sup>2</sup></b>

<sup>1</sup> DLA responded to a working draft by saying that the problem with the general purpose trunks, physical fitness uniforms was caused by depot storage not a FPI manufacturing error.

<sup>2</sup> We calculated the dollar value of the potential replacements by multiplying the estimated contract unit price times the number of defective items. This calculation does not include the total replacements received by Defense Supply Center Richmond.

## Appendix H. Comparison of Delinquent FPI and Commercial Deliveries

### Analysis of Federal Prison Industries, Inc. Contracts<sup>1</sup>

Item	Contract	IPP <sup>2</sup> Item	Contract Deliveries		Days Late <sup>3</sup>
			Number of Deliveries	Number Delinquent	
Shirt	96DCA03	No	12	2	34
Trunks	96DCA25	No	31	3	27
Undershirt	96DCB62	Yes	11	6	266
Jacket	96DCB71	No	13	2	2
Trunks	96DCB85	No	18	8	145
ECWCS <sup>4</sup> Trousers	96DEG07	Yes	15	9	305
Shirt	96FCB20	No	10	10	1,977
BDU <sup>5</sup> Trousers	97DCB10	Yes	17	2	50
BDU <sup>5</sup> Coat	97DCB11	Yes	6	4	135
Body Armor	97FEA01	Yes	12	9	338
Jacket	98DCA04	No	3	1	31
<b>Total</b>			<b>148</b>	<b>56</b>	<b>3,310</b>

<sup>1</sup> The methodology used to determine a delinquency is discussed in Appendix C, Question 2.

<sup>2</sup> Industrial Preparedness Planning item that are required for mobilization.

<sup>3</sup> Days late represent the total number of days late for all delivery delinquencies.

<sup>4</sup> Extended cold weather clothing system.

<sup>5</sup> Battle dress uniform

## Appendix H. Comparison of Delinquent FPI and Commercial Deliveries

### Analysis of Commercial Contracts<sup>1</sup>

Item	Contract	IPP Item <sup>2</sup>	Contract Deliveries		
			Number of Deliveries	Number Delinquent	Days Late <sup>3</sup>
Undershirt	96D1025	Yes	12	8	199
Jacket	97C1018	No	6	6	110
Jacket	97C1004	No	9	9	270
ECWCS <sup>4</sup> Trousers	97C5104	Yes	3	1	5
BDU <sup>5</sup> Trousers	96D0332	Yes	35	1	2
Gloves	96D4012	No	22	7	343
Body Armor	97C5046	Yes	7	2	21
<b>Total</b>			<b>94</b>	<b>34</b>	<b>950</b>

<sup>1</sup> The methodology used to determine a delinquency is discussed in Appendix C, Question 2.

<sup>2</sup> Industrial Preparedness Planning item that are required for mobilization.

<sup>3</sup> Days late represent the total number of days late for all delivery delinquencies.

<sup>4</sup> Extended cold weather clothing system.

<sup>5</sup> Battle dress uniform.

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## **Appendix I. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition and Technology  
Deputy Under Secretary of Defense (Acquisition Reform)  
Deputy Under Secretary of Defense (Logistics)  
Director, Defense Logistics Studies Information Exchange  
Director, Defense Procurement  
Director, Small and Disadvantaged Business Utilization  
Under Secretary of Defense (Comptroller)  
Deputy Comptroller (Program/Budget)  
Deputy Chief Financial Officer  
Assistant Secretary of Defense (Public Affairs)

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Financial Management)  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force

### **Other Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Logistics Agency  
Commander, Defense Supply Center - Columbus  
Commander, Defense Supply Center - Philadelphia  
Commander, Defense Supply Center - Richmond

**Non-Defense Federal Organizations**

Office of Management and Budget  
Office of Federal Procurement Policy  
Technical Information Center, National Security and International Affairs Division,  
General Accounting Office  
Small Business Administration

**Chairman and Ranking Minority Member of each of the  
Following Congressional Committees and Subcommittees**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Government Affairs  
House Committee on Appropriations  
House Subcommittee on National Security, Committee on Appropriations  
House Committee on Government Reform and Oversight  
House Subcommittee on Government Management, Information and Technology,  
Committee on Government Reform and Oversight  
House Committee on National Security





## **Part III – Management Comments**

# Office of the Under Secretary of Defense Comments



ACQUISITION AND  
TECHNOLOGY

## OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3000

August 24, 1998

DP/CPA

MEMORANDUM FOR DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE, DOD  
INSPECTOR GENERAL

SUBJECT: Draft Audit Report of Defense Logistics Agency  
Procurements from Federal Prison Industries, Inc.  
(Project No. 7CF-5054)

This is in response to your memorandum of June 17 requesting  
comments on the findings and recommendations in the subject draft  
report.

Please find attached our comments on those recommendations  
that apply to Defense Procurement.

Eleanor R. Spector  
Director, Defense Procurement

Attachment



PROJECT NUMBER 7CF-5054

"Audit Report of Defense Logistics Agency Procurements  
from Federal Prison Industries, Inc."

DEFENSE PROCUREMENT COMMENTS

\* \* \* \* \*

RECOMMENDATIONS

RECOMMENDATION A: DISPUTE RESOLUTION.

A.1. We recommend that the Director, Defense Procurement initiate revisions to the Federal Acquisition Regulation subpart 8.6 "Acquisition from Federal Prison Industries, Inc." that:

- a. Refers buyers to the Ombudsman as the approved method of resolving disputes pertaining to price, quality, suitability, and character of FPI products, and
- b. Uses the word "clearance" instead of "waivers" to relate the terminology used with customer disputes.

DP RESPONSE: Partially Concur. While we agree that the FPI Ombudsman is currently the primary adjudicator of disputes with FPI, the arbitration board referred to in FAR 8.605(c) is being established. Until the new board has developed procedures, to include its relationship with the FPI Ombudsman, it is premature to make any changes to FAR 8.6 in this regard.

Recommendation A.1.b is worded incorrectly. The FAR currently uses the term "clearances" instead of "waivers." FPI grants waivers, not clearances, to customers. We agree that the term "waiver" should be substituted in FAR 8.6 for the term "clearance" wherever it appears.

RECOMMENDATION B: NEGOTIATED PRICES FOR MANDATORY SUPPLIES.

B.1. We recommend that the Director, Defense Procurement propose a revision to the FAR to eliminate language in subpart 8.605(b), which states that price will not normally be the basis for a waiver and insert:

- a. A definition of current market price and how to determine current market price when:
  - (1) The supplies being purchased are of the kind generally bought and sold on the commercial market.

(2) The supplies are manufactured in accordance with Government specifications.

b. A requirement that waivers should be requested when the proposed price significantly exceeds the current market price.

DP RESPONSE: Non-concur. The FAR contains a definition of the term "fair market price" (Part 19.001, Definitions) and an explanation of how to determine fair market price at FAR 19.202-6 and 19.807. FAR 15.404-1(b) contains information on how to conduct a price analysis of the kind called for in recommendation B.1.a. The term "current", when attached to fair market price, is self-explanatory and needs no further definition. This information is taught to contracting personnel as part of their required training. It would be redundant to repeat this information elsewhere in the FAR.

FAR 8.604(c) states "When the contracting officer believes that the FPI price exceeds the market price, the matter may be referred to the cognizant product division identified in the Schedule or to the FPI Washington office for resolution." This is also self-explanatory. We believe contracting officers have flexibility to determine whether a waiver should be requested and that mandating a waiver as proposed in B.1.b when the price significantly exceeds the current market price is unnecessary.

The recommendation also asks that DDP propose a revision to the FAR to eliminate language which states that price will not normally be the basis for a waiver. DoD is preparing a report to Congress that will address a number of issues concerning the way we do business with FPI. We prefer to negotiate with FPI any proposed FAR changes emanating from that report at the conclusion of the report. The change the IG recommends will be considered.

# Defense Logistics Agency Comments



**DEFENSE LOGISTICS AGENCY**  
**HEADQUARTERS**  
8725 JOHN J. KINGMAN ROAD, SUITE 2533  
FT. BELVOIR, VIRGINIA 22060-6221

IN REPLY  
REFER TO

DDAI

12 Aug 96

**MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE**  
**ATTN: Director, Contract Management Directorate**

**SUBJECT: Audit Report of Defense Logistics Agency Procurements from Federal Prison Industries, Inc.**  
**(Project No. 7CF-5054)**

Enclosed are DLA comments in response to your 17 Jun 96 request. If you have any questions,  
please contact Ms. Mimi Schirmacher, 767-6263.

Enc1

  
**SHEILA P. RAINES**  
Team Leader, Liaison & Policy  
Internal Review Office

## Defense Logistics Agency Comments

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**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**FINDING A: Dispute Resolution.** The statutory process and regulatory procedures for resolving disputes and appealing waiver denials is unworkable and is not being used by Federal Prison Industries, Inc., or Government customers. This condition exists because FAR subpart 8.6, "Acquisition from Federal Prison Industries, Inc." guidance has not been revised to clearly establish procedures for processing waivers and resolving disputes between FPI and its customers. As a result, DoD lacks effectiveness for initiating or appealing waiver requests and for resolving disputes regarding the price, quality, character, or suitability of FPI supplies.


**DLA COMMENTS:** Nonconcur. Whatever the state of procedures for resolving disputes and appealing waiver denials, the solution is not to revise FAR guidance. As stated in the Justice Department decision and acknowledged in the Draft Audit Report, the FAR, except for Subpart 8.6, is generally inapplicable to FPI. The FAR governs contractual relationships between the Government and private-sector contractors. FPI is a Government corporation under the Bureau of Prisons in the Justice Department. Coverage on FPI appears in FAR Subpart 8.6 in order to put contracting officers and contractors on notice that, by statutory mandate, the Government is obligated to contract with this source. All the coverage contained therein has to do with fulfillment of the mandate; further procedural detail does not belong there. Procedural guidance regarding the FPI appeal process belongs elsewhere in the Code of Federal Regulations and/or in Departmental instructions. This latter issue needs to be addressed at the OSD level.

**ACTION OFFICER:** Mary Massaro, DLSC-PPP

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**

  
E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION A.2.a:** Recommend the Director, Defense Logistics Agency revise Defense Logistics Agency Directive 4105.1 "Defense Logistics Acquisition Directive," subpart 8.6 "Acquisition from Federal Prison Industries, Inc." to comply with Federal Acquisition Regulation subpart 8.6 and the 1993 Department of Justice Legal Opinion pertaining to Federal Prison Industries, Inc.

**DLA COMMENTS:** Concur. We agree that DLAD 4105.1, Subpart 8.6, requires revision. As a point of information, the sections within subpart 8.7 (8.706, 8.790, and 8.791) to which it currently refers were removed from the DLAD via PROCLTR 97-34, Ensuring Adequate JWOD Participation in DLA's New Business Initiatives (December 10, 1997).

**DISPOSITION:**

- (X) Action is ongoing. ECD: December 1998.
- ( ) Action is complete.

**ACTION OFFICER:** Mary Massaro, DLSC-PPP

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive  
Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## Defense Logistics Agency Comments

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION A.2.b:** Recommend the Director, Defense Logistics Agency revise Defense Logistics Agency Directive 4105.1 "Defense Logistics Acquisition Directive," subpart 8.6 "Acquisition from Federal Prison Industries, Inc." to refer buyers to the Ombudsman as the approved method of resolving disputes pertaining to price, quality, suitability, and character of FPI products.

**DLA COMMENTS:** Concur. Notwithstanding our general statement (at A.2.c, below) that detailed DLAD coverage (in that case, for waiver appeals) should not be drafted until after results of a statutorily-based DoD/FPI study group have been published, the Ombudsman procedure seems like such a simple, universally-recognized solution that its treatment in 8.6 already seems appropriate and unlikely to change. Will accomplish this as part of the complete revision of DLAD 4105.1, Subpart 8.6, mentioned in our response to Recommendation A.2.a.

**DISPOSITION:**

- (X) Action is ongoing. ECD: December 1998.
- ( ) Action is complete.

**ACTION OFFICER:** Mary Massaro, DSLC-PPP

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director



**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION A.2.e:** Recommend the Director, Defense Logistics Agency revise Defense Logistics Agency Directive 4105.1 "Defense Logistics Acquisition Directive," subpart 8.6 "Acquisition from Federal Prison Industries, Inc." to include criteria determining when to request a waiver to purchase Federal Prison Industries, Inc. mandatory products from commercial vendors and also the criteria for appealing a waiver denial.

**DLA COMMENTS:** Nonconcur. There is currently underway an initiative which could have an impact on DLA's, and all of DoD's, relationship with FPI: the FY 98 National Defense Authorization Act-mandated joint DoD/FPI study group addressing the entire statutory, regulatory, and procedural framework governing that relationship. Prior to completion and release of its study output, it would be premature for us to establish headquarters-level criteria for determining when a waiver request would be appropriate, or for appeal of waiver denials. (Personnel from DLSC-P and DDAS represent DLA on the study group.)

**DISPOSITION:**


( ) Action is ongoing. ECD:  
(X) Action is complete.- pending submission and release of the study group's report.

**ACTION OFFICER:** Mary Massaro, DLSC-PPP

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive  
Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schimmacher, DDAI

**DLA APPROVAL:**

  
E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## Defense Logistics Agency Comments

---

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**FINDING B: Negotiating Prices for Mandatory Supplies.** Defense Supply Center (DSC), Richmond contracting officers paid higher prices than necessary for supplies purchased from both FPI and commercial vendors. Contracting officers at DSC, Richmond did not always use price analysis to evaluate proposals or negotiate prices, when the proposed price was above the current market price. As a result, buyers missed opportunities to reduce the cost of supplies when purchasing items manufactured by both Federal Prison Industries, Inc. and commercial vendors. In contrast, DSC, Philadelphia used cost or price analysis and successfully negotiated more reasonable prices.


**DLA COMMENTS:** Partially Concur. DSC Richmond (DSCR) is in the process of establishing new Long Term Contracts (LTCs) which focus on improved pricing with FPI. Use of the LTCs should greatly minimize instances of DSCR paying above current market prices.

**ACTION OFFICER:** Dorothy Howard, DSCR-DI/Diana Maykowskyj, DLSC-POA

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**

  
E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION B.2.a:** Recommend the Commander, Defense Supply Center Richmond establish additional training requirements for buyers and contracting officers purchasing from Federal Prison Industries, Inc. The training should include cost and price analysis techniques and reemphasis of the requirements to perform price analysis to complement cost or other analysis.


**DLA COMMENTS:** Concur. DSC Richmond will provide training for buyers and contracting officers on purchasing from FPI. The training will include cost and price analysis techniques, with emphasis on performing price analysis to complement cost or other analysis.

**DISPOSITION:**

- ☒ Action is ongoing. ECD: March 31, 1999
- ☐ Action is complete.

**ACTION OFFICER:** Dorothy Howard, DSCR-DI/ Diana Maykowskyj, DLSC-POA  
**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P  
**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**

  
E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## Defense Logistics Agency Comments

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION B.2.b:** Recommend the Commander, Defense Supply Center Richmond (DSCR) establish additional training requirements for buyers and contracting officers purchasing from Federal Prison Industries, Inc. The training should include negotiating procedures when analysis shows that either Federal Prison Industries, Inc. or commercial suppliers quote prices substantially greater than the current market price.

**DLA COMMENTS:** Concur. DSCR will provide training for buyers and contracting officers in Negotiation Techniques. The training will emphasize procedures for analyzing prices quoted substantially greater than the current market price.

**DISPOSITION:**

(X) Action is ongoing. ECD: March 31, 1999

( ) Action is complete.

**ACTION OFFICER:** Dorothy Howard, DSCR-DI/Diana Maykowskyj, DSLC-POA

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION B.L.c:** Recommend the Commander, Defense Supply Center Richmond (DSCR) establish additional training requirements for buyers and contracting officers purchasing from Federal Prison Industries, Inc. The training should include the conditions for requesting a waiver from Federal Prison Industries, Inc. and what action to take if they deny the waiver.

**DLA COMMENTS:** Partially Concur. DSCR has scheduled training in the waiver/clearance process during the first quarter of FY 99. The entire waiver/clearance process is cumbersome and slow. DSCR will review and make changes to streamline the process.

**DISPOSITION:**

- ☒ Action is ongoing. ECD: December 31, 1999
- ☐ Action is complete.

**ACTION OFFICER:** Dorothy Howard, DSCR-DI/Diana Maykowskyj, DLSC-POA

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## Defense Logistics Agency Comments

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**FINDING C: Exercising Federal Prison Industries, Inc. Warranty.** Defense supply centers did not always obtain replacements for defective supplies manufactured by FPI. This occurred because Defense supply centers did not notify FPI about the defective supplies in order to exercise the warranty. Defense Logistics Agency guidance is incomplete pertaining to the lifetime warranty provided by FPI. As a result, the Defense supply centers missed the opportunity to replace about \$127,000 in defective items at no cost to Defense Logistics Agency.


**DLA COMMENTS:** Concur. DLA agrees that the Defense Supply Centers did not always obtain replacements for defective supplies manufactured by FPI and that FPI was not notified in every case about defective supplies. DLA ICPs will be required to follow current DLAD 4155.2 policy on contractor notification that requires PQDRs to be provided through DCMC to the contractor for source inspected items and directly to the contractor for destination-inspected items. Agency guidance in DLAI 4155.2, Quality Assurance Program Instruction for DLA ICPs, will be revised to state that the life warranty provided by FPI applies to all products produced by FPI.

**ACTION OFFICER:** Dunne Rice, DLSC-LEQ

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**

  
E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## Defense Logistics Agency Comments

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION C.1.a:** Recommend that the Headquarters, Defense Logistics Agency revise Defense Logistics Agency Manual 4155.2, 4-6, "Customer/Depot Complaints (CDCs)/Product Quality Deficiency Reports (PDQRs)," to state that the Federal Prison Industries, Inc. lifetime warranty applies to all of its supplies.

**DLA COMMENTS:** Concur. The Defense Logistics Agency Instruction (DLAI) 4155.2, Quality Assurance Program Instruction for the DLA ICPS (which replaces DLAM 4155.2) will be amended to state "If there is no explicit warranty clause, but it is known that the contractor provides limited or lifetime warranties on their products, this warranty shall be used. One example of this is the lifetime warranty provided by the Federal Prison Industries (UNICOR) on all items they supply."

**DISPOSITION:**

- (X) Action is ongoing. ECD: September 30, 1998
- ( ) Action is complete.

**ACTION OFFICER:** Dunne Rice, DLSC-LEQ

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## **Defense Logistics Agency Comments**

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**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION C.1.b:** Recommend that the Headquarters, Defense Logistics Agency require Defense supply centers to exercise the Federal Prison Industries Inc. warranty provisions for their products.

**DLA COMMENTS:** Concur. The Defense Supply Centers will be required to exercise FPI warranty provisions.

**DISPOSITION:**

- ( ) Action is ongoing. ECD:
- (X) Action is complete.

**ACTION OFFICER:** Duane Rice, DLSC-LEX

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive  
Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director



## Defense Logistics Agency Comments

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION C.2:** Recommend the Commander, Defense Supply Center Philadelphia (DSCP) request Federal Prison Industries, Inc. to replace supply items associated with the 296 Product Quality Deficiency Reports that we reviewed.

**DLA COMMENTS:** Concur. DSCP concurs with the recommendation. However, not all of the 296 Product Quality Deficiency Reports (PQDRs) were candidates for product replacement by the Federal Prison Industries (FPI). Some of the PQDRs were caused by the government. The FPI will be requested to replace supply items associated with PQDRs, which they caused.

**DISPOSITION:**

- (X) Action is ongoing. ECD: December 1998
- ( ) Action is complete.

**ACTION OFFICER:** Mr. Louis DeMarchis, DSCP-DI/Diana Maykowsky, DLSC-POA

**REVIEW/APPROVAL:** Pete Ranfola, Chief, Acquisition Programs Team

**COORDINATION:** RAD (Sel) Gwilym Jenkins, Acting Executive Director

**DLA APPROVAL:**



R.R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## **Defense Logistics Agency Comments**

**SUBJECT:** Defense Logistics Agency Procurements from Federal Prison Industries, Inc. (Project No. 7CF-5054)

**RECOMMENDATION C.3:** Recommend the Commander, Defense Supply Center Columbus request Federal Prison Industries, Inc. to replace supply items associated with the 7 Product Quality Deficiency Reports that we reviewed.

**DLA COMMENTS:** Concur. After the audit, DSCC reviewed the 7 Product Quality Deficiency Reports in question and assured that all actions of replacement were taken for all the supplies involved that needed to be repaired or replaced. Details on each of the 7 cases is attached.

**DISPOSITION:**

- ( ) Action is ongoing. ECD:
- (X) Action is complete.

**ACTION OFFICER:** Duane Rice, DLSC-LEQ

**REVIEW/APPROVAL:** Gwilym H. Jenkins, Jr., CAPT, SC, USN, Acting Executive Director, Procurement Management Directorate, DLSC-P

**COORDINATION:** Mimi Schirmacher, DDAI

**DLA APPROVAL:**



E. R. CHAMBERLIN  
Rear Admiral, SC, USN  
Deputy Director

## **Audit Team Members**

**This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD.**

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